GENERAL INDEX

NOTE.—The principal argument is in No. 420.

No. 337. THE UNITED STATES, APPELLANT, v. P. CHAUNCEY ANDERSON ET AL.

INDEX

CASE CITED

STATUTE

In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 337

THE UNITED STATES, APPELLANT

v.

P. CHAUNCEY ANDERSON ET AL.

APPEAL FROM THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION IN THE COURT BELOW

The opinion of the Court of Claims is not yet reported. It is in the record at page 17.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered in the Court of Claims January 5, 1925. (R. 19.)

Appeal was allowed March 16, 1925 (R. 19), under Sections 242 and 243, Judicial Code.

STATEMENT

This case is similar to No. 420, *The United States, Appellant,* v. *The Yale & Towne Manufacturing Company.* The question is whether the munitions tax for 1916 was deductible in computing the net taxable income of the Burton-

Richards Company for 1916, or whether the item was deductible in computing the income for 1917. During the year 1916 the company was engaged in the manufacture and sale of munitions, from which it made a profit of $899,356.32, on which it was required to pay a munitions tax for the year 1916 of 12½ per cent, amounting to $112,419.54. (R. 1–2.) In keeping its books of account the company during the year 1916 accrued and set up on its books various items of income and expense regardless of whether they were due or were paid in that year. Among other items, it set up in 1916 a reserve for munitions taxes for the year 1916, beginning with September, the month of the passage of the Munitions Tax Act, setting aside each month the sum of $35,000. Before closing its books for the year, and under date of December 31, 1916, it readjusted the munitions tax reserve by recalculating the amount and then set up a reserve of $86,541.95 as the amount of the munitions tax, the entry of which on the books operated to reduce the profits of the corporation for the year. (R. 13–15.) In March, 1917, the munitions tax return was filed, showing a tax of $86,541.95. (R. 13.) Thereafter, an examination conducted by the Commissioner of Internal Revenue resulted in the increase of the tax to $112,419.54. (R. 13.) This increase resulted from the fact that in setting up its accounts for 1916 the corporation had charged off as depreciation the entire value of its munitions plant, then in opera-

tion, a depreciation charge which was afterwards disallowed by the Commissioner, who allowed only 10 per cent of the value of the plant as a depreciation charge for 1916.

A statement of the applicable statutes will be omitted because incorporated in the brief in No. 420. The only essential difference between the cases is that in No. 420 it is established that the accounts of the corporation for 1916 were kept on an accrual basis and its income-tax return for that year was made on an accrual basis, while in this case the appellees not only make every point urged by the appellee in No. 420, but also assert that the company's books were kept on a cash receipts and disbursements basis and its return was made on that basis.

ASSIGNMENT OF ERRORS

1. The court erred in holding that the munitions tax on the company's profits for 1916 did not accrue until it became due and payable in 1917.

2. The court erred in holding that, although the company's books of account were kept on an accrual basis and its income-tax return for 1916 was made on the basis on which its books of account were kept, and although the munitions tax for 1916 was entered on its books for 1916 as an accrued liability, it was entitled to deduct the munitions tax in calculating its net taxable income for 1917.

3. The court erred in rendering judgment for the appellees.

ARGUMENT

Summary

I. The only respect in which this case differs from No. 420, The United States, Appellant, v. The Yale & Towne Manufacturing Company, is because of a dispute as to whether the taxpayer's books were kept and its income-tax return made on a cash basis or an accrual basis. As shown in the brief in No. 420, if the cash basis was used, the deduction of the munitions tax for 1916 was properly made in the income-tax return for 1917, the year in which it was paid.

If the accrual basis was used, the deduction could only be made in the income-tax return for 1916, in which year the munitions tax accrued.

II. The Findings show that the books were kept and the return made on the accrual basis.

III. In this, a suit to recover taxes paid, the burden is on the taxpayer to show that the tax was illegally assessed and to overcome the prima facie validity of the assessment, and unless the Findings of the Court of Claims affirmatively show that the books were kept and the income-tax return made on a cash basis they do not sustain the judgment.

IV. Conclusion.

I

The only respect in which this case differs from No. 420, The United States, Appellant, v. The Yale & Towne Manufacturing Company, is because of a dispute as to whether the taxpayer's books were kept on a cash or an accrual basis

If the contention of the taxpayer is right that the Findings by the Court of Claims show that

in 1916 its accounts were kept on a cash basis or that its income-tax return for that year was made on that basis, there is nothing more to be said, because in that case the munitions tax was deductible in the year in which it was paid and not in the year in which it accrued. On the other hand, if the taxpayer's books were kept and its income-tax return for 1916 made on the accrual basis, the principles presented in the Government's brief in No. 420, *The United States, Appellant,* v. *The Yale & Towne Manufacturing Company,* are applicable and the munitions tax for 1916 would be deductible only in 1916, because it accrued in 1916.

In this case the appellees argue that the fact that the munitions tax, accrued on the corporation's books at $86,541.95, was increased by the Commissioner of Internal Revenue to $112,-419.54, shows that the amount of tax at the close of business December 31, 1916, was so uncertain as not to justify an attempt to accrue it, although the taxpayer did make that attempt. This is an unfortunate argument for the appellees. The reason that the increase was made is that the taxpayer charged off as depreciation in computing its profits, on which the munitions tax of 12½ per cent was based, the entire value of its munitions plant, although the plant was still in existence and was being used. This circumstance shows that the failure to accrue the tax at approximately the correct amount resulted from an obviously unjust depreciation charge made by the taxpayer.

II

The Findings show that the books were kept and income-tax return made on an accrual basis

The Findings of the Court of Claims are somewhat meager. They do show that in keeping its books of account the taxpayer set up during the year 1916 a reserve for taxes which were not yet due and which had not been paid. (Finding V, R. 13.) To this extent it is obvious that the books were kept on an accrual basis, and the inference being justified that the taxpayer was consistent it would follow that, in the absence of an express Finding to the contrary, all its accounts were kept on an accrual basis. There is a Finding that expenses amounting to over $2,000,000 "were accrued on the books of the corporation and were taken as deductions without regard to whether said items were paid during 1916 or subsequent years," and among these items were insurance reserve, freight reserve, and bonus reserve. (Finding VIII, R. 14, 15.) These items were the largest items on the books, and, being found by the Court of Claims to have been kept on an accrual basis, sufficiently show that the books of account were kept on an accrual basis. The Finding that no interest was entered on the books for 1916, except such as was actually received or paid (Finding VII, R. 14), is of no significance, because it is expressly found that no other items of interest existed.

The Findings are susceptible only of the construction that the accounts were kept on an accrual basis.

The next question is whether the Findings show that the taxpayer made its return on the basis on which its books were kept (accrual basis) or whether a return was made on a receipts and disbursements basis.

There is no express Finding that the income-tax return for 1916 was or was not made on the basis on which the accounts were kept—that is, on an accrual basis. There are Findings that the item of accrued munitions tax for 1916 carried on the books was omitted from the income tax return for 1916, but reported as a deduction in the return for 1917. (Findings VII, XII, R. 14, 16.) To this extent, and this extent only, the Findings show affirmatively that the basis on which the books of account were kept was departed from in making the income-tax return.

From the other Findings it is fairly inferable that, except for the accrued munitions tax, the income-tax return for 1916 corresponded with the books of account, and the books of account, as the Findings clearly show, were kept on an accrual basis.

There is an express Finding that "accrued" general expenses were "taken as deductions" (Finding VIII, R. 14, 15), which means, no doubt, deductions in the income-tax return, and shows that the return was made on an accrual basis.

III

The burden is on the taxpayer, and unless the Findings affirmatively show that the return was made on a receipts and disbursements basis they do not sustain the judgment

In this case the taxpayer seeks to recover a tax paid, on the ground that it was illegally assessed. The burden of proof is upon him. Furthermore, the assessment by the Commissioner of Internal Revenue is *prima facie* valid and regular. *United States* v. *Rindskopf,* 105 U. S. 418.

If the Findings fail to show affirmatively that the books were kept and the income-tax return made on the accrual basis, it is certain they do not show affirmatively that the return was made on a cash basis, and only an affirmative Finding that the income-tax return for 1916 was made on a cash basis would support the judgment against the United States.

CONCLUSION

For the reasons above stated, and those given in the brief in No. 420, the judgment should be reversed.

WILLIAM D. MITCHELL,
Solicitor General.
JOHN B. MILLIKEN,
Special Attorney,
Bureau of Internal Revenue.

OCTOBER, 1925.

No. 420. THE UNITED STATES, APPELLANT, v. THE YALE & TOWNE MFG. CO.

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CASES CITED

TEXTBOOKS

STATUTES

In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 420

THE UNITED STATES, APPELLANT,

v.

THE YALE & TOWNE MANUFACTURING COMPANY

APPEAL FROM THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION IN THE COURT BELOW

The memorandum opinion of the Court of Claims, adopting in this case the opinion in the case of *P. Chauncey Anderson et al.* v. *The United States* (No. 337, October Term, 1925), is not yet reported. It is found at R. 14.

The opinion in the *Anderson* case is not yet reported. It is found at page 17 of the record in No. 337.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered in the Court of Claims March 23, 1925 (R. 14). Appeal was allowed April 20, 1925 (R. 15), under Sections 242 and 243, Judicial Code.

STATEMENT

This case presents the question whether in computing net taxable income under the Revenue Act of 1916 a munitions tax was deductible from gross income for the year in which the munitions tax was paid or in the year in which it accrued, requiring, in the latter case, a decision as to whether the munitions tax could properly be accrued under an accrual system of accounting in the year in which it was imposed, or only in the year in which it became due.

The appellee, a Connecticut corporation, was engaged in 1916 in manufacturing munitions, its munitions profits for 1916 being $2,045,574, on which there was imposed a munitions tax of 12½ per cent, or $255,696.73. The munitions tax for 1916 became due and was paid in 1917. (R. 11, 12.) The deductibility of the munitions tax in determining net taxable income, for income and excess-profits purposes, is conceded.

The dispute is with respect to the year in which the deduction may be taken.

The Government contends that the deduction should be taken in the income-tax return for 1916; the taxpayer contends that it should be taken in the 1917 return.

The appellee kept its books of account, not on a cash—i. e., a receipts and disbursements basis—but on an accrual basis (R. 12), and made its income-tax return on that basis.

Under that system it set up on its books in 1916 every obligation or expense accruing or incurred without regard to whether it fell due or was paid during the year. (R. 12, 13.)

As part of that system it accrued on its books of account before they were closed for the year 1916, taxes of various kinds for the year 1916, incurred by reason of operations for that year, without regard to whether they were paid or due in that year. The entry was in the form of "reserve for taxes" appearing in the liability column and operating to reduce the amount of the net profits for that year. (R. 12–13.) Included in this reserve was an item of $247,763.19 for munitions tax for the year 1916. (R. 13.)

In February, 1917, a munitions-tax return was filed by the appellee on that basis, and that amount was paid in May, 1917. The return was reviewed by the Collector and an additional munitions tax of $7,933.60 was assessed, which was paid in July, 1917. (R. 12.)

The law required a return of the munitions tax for 1916 to be filed on or before March 1, 1917, and required payment within 30 days after notice from the Commissioner of Internal Revenue, who was required to assess the taxes and issue the notice promptly after the filing of the return. (Sections 304 and 305, Title III, Revenue Act of September 8, 1916, Chap. 463, 39 Stat. 756, 781–782.)

The appellee made its income and excess profits tax return for the year 1916 on the basis on which its books had been kept (the accrual basis), except in so far as it departed from that basis by omitting from its return as an accrued expense or liability the amount of the munitions tax which appeared in its books of account for 1916 as an accrued expense.

In 1918, when making its income tax returns for 1917, appellee treated the munitions tax for 1916 as a deduction or expense for 1917, the year in which it fell due and was paid.

Later, the Commissioner of Internal Revenue held that the munitions tax should have been deducted in the income tax return for 1916 instead of in the return for the year 1917, and the resulting adjustment in these two years, after crediting on the 1917 tax the overassessment for 1916, resulted in a net increase in the 1917 income and profits taxes of $116,044.40, which was assessed and paid under protest, and for the recovery of which after refund was applied for and refused this suit was brought. (R. 9, 10, 12, 14.)

Judgment went against the United States in the Court of Claims.

THE QUESTION

The question is whether the taxpayer, keeping its books of account for 1916 on the accrual basis, and accruing the munitions tax for 1916 on its books as an accrued expense for that year, and

making its income-tax return on the basis on which its books were kept (except in so far as it may have departed from that basis by omitting to make a deduction of the munitions tax for 1916), had the right to deduct the amount of the munitions tax for 1916 from its gross income for 1917, the year in which the munitions tax fell due and was paid, or whether the deduction could only be made in computing its income for the year 1916. In other words, the question is whether the munitions tax was deductible in the year in which it was paid or in the year in which it accrued, and whether it did accrue in 1916 or 1917.

THE STATUTES

The Revenue Act of 1916, Chap. 463, 39 Stat. 756, 765, 767–768, 770–771, 780–781, provides so far as pertinent to this case:

PART II. ON CORPORATIONS

> SEC. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized but not including partnerships, a tax of two per centum upon such income
> * * *.
> * * * * *

DEDUCTIONS

SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties * * *.

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade * * *.

Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding * * *.

Fourth. Taxes paid within the year imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipal-

ity, or other taxing subdivision of any State, not including those assessed against local benefits.

* * * * *

RETURNS

SEC. 13 (a) The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December thirty-first * * *.

* * * * *

(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned * * *.

The munitions tax provisions are as follows:

TITLE III. MUNITION MANUFACTURER'S TAX

SEC. 300. That when used in this title—

The term "person" includes partnerships, corporations, and associations * * *.

SEC. 301. (1) That every person manufacturing (a) gunpowder and other explosives * * * shall pay for each taxable year, in addition to the income tax imposed by Title I, an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for said

year from the sale or disposition of such articles manufactured within the United States * * *.

SEC. 302. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States the following items:

(a) The cost of raw materials entering into the manufacture;

(b) Running expenses, including rentals, cost of repairs and maintenance, heat, power, insurance, management, salaries, and wages;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the manufacture;

(e) Losses actually sustained within the taxable year in connection with the business of manufacturing such articles, including losses from fire, flood, storm, or other casualty, and not compensated for by insurance or otherwise; and

(f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants.

On January 8, 1917, before the income tax returns for 1916 were required to be made, the Treasury Department, pursuant to Section 13 (d) of Part II of the Act of 1916, issued Treasury Decision 2433 as follows (Treasury Decisions, Vol. 19, p. 5):

> Corporations keeping books in accordance with standard systems of accounting or in conformity with the requirements of some Federal, State, or municipal authority having supervision over such corporations, may make their returns on the basis on which their books are kept, provided the books so kept and the returns so made reflect the true net income of the corporations for each year. [Syllabus.]
>
> TREASURY DEPARTMENT,
> OFFICE OF COMISSIONER
> OF INTERNAL REVENUE,
> *Washington, D. C., January 8, 1917.*
>
> *To collectors of Internal Revenue:*
>
> Subparagraph (d) of Section 13, of Title I of the act of September 8, 1916, provides that—
>
> "A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case

the tax shall be computed upon its income as so returned."

Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the re-

serves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated, shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its

returns upon any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:

W. G. MCADOO,
Secretary of the Treasury.

ASSIGNMENT OF ERRORS

1. The court erred in holding that the munitions tax on the appellee's profits for 1916 did not accrue until it became due and payable in 1917.

2. The court erred in holding that although the appellee's books of account were kept on an accrual basis and its income-tax return for 1916 was made on the basis on which its books of account were kept, and although the munitions tax for 1916 was entered on its books for 1916 as an accrued liability, it was entitled to deduct the munitions tax in calculating its net taxable income for 1917.

3. The court erred in rendering judgment for the appellee.

ARGUMENT

Summary

I. Under the Revenue Act of 1916 a taxpayer was required to make his income-tax return on the basis of receipts and disbursements, unless he kept his books on an accrual basis, in which case he was permitted to make his return on the basis on which his books were kept.

II. In the present case, as the taxpayer kept its books on the accrual basis and made its income-tax return on that basis, all items of expense, including taxes, must be dealt with on the accrual basis and deductions therefor taken in the year in which the items accrued as distinguished from the year in which they were paid.

III. Under the accrual system of accounting a liability or expense is accrued when all the events have occurred by which liability is determined and the liability has become fixed, even though payment is not due.

The munitions tax for 1916 accrued in 1916, and this taxpayer made no mistake in entering the item on its books for that year as an accrued expense; and in determining its net taxable income the munitions tax was deductible from gross income for the year 1916 and not in the return for 1917.

IV. The cases of United States v. Woodward, 256 U. S. 632, and Ed. Schuster & Co., Inc., v. Williams, 283 Fed. 115, properly understood, do not support the view that a tax, other than an estate tax, does not accrue and is not properly susceptible of being accrued under the accrual system of accounting until it is due.

V. Conclusion.

I

Under the Revenue Act of 1916 a taxpayer was permitted to make his income-tax return on an accrual basis if his books were kept on that basis

A proper understanding of this case requires a review of legislation dealing with the basis for computing Federal income taxes.

The Corporation Excise Tax Law of 1909, Chap. 6, 36 Stat. 11, 112, 113, imposed an annual excise tax upon "the entire net income * * * [of a corporation] received by it from all sources," and provided that such net income be ascertained by deducting from

> the gross amount of the income * * * received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties * * *; (second) all losses actually sustained within the year * * *; (third) interest actually paid within the year on its bonded or other indebtedness * * *; (fourth) all sums paid by it within the year for taxes * * *.

That statute plainly required the computation of net income on the basis of actual receipts and disbursements. There was no provision for accrual systems of accounting or for including items of expense incurred but not due and paid.

The first corporation income tax Act of October 3, 1913, under subdivision G of Section II, Chap. 16, 38 Stat. 114, 172, 173, imposed a tax on

> the entire net income arising or accruing from all sources during the preceding calendar year to every corporation,

and provided that such net income should be ascertained

> by deducting from the gross amount of the income of such corporation * * * received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business * * *; (second) all losses actually sustained within the year * * *; (third) the amount of interest accrued and paid within the year on its indebtedness * * *; (fourth) all sums paid by it within the year for taxes * * *.

cash basis

This statute, like the 1909 Act, provided for the calculation of net taxable income on the receipts and disbursements basis.

Under these two Acts some departures from the strict receipts and disbursements basis were permitted by the Commissioner of Internal Revenue, such as the use of inventories. This legislation shows that the subject was undeveloped and the resulting system was a mongrel one, but, in the main, the returns were required to be made on a receipts and disbursements basis. (*Lumber Mutual Fire Ins. Co.* v. *Malley*, 256 Fed. 380; *Maryland Casualty Co.* v. *United States*, 52 Ct. Cls. 201; same case, 251 U. S. 342.)

The first decided shift occurred in the Revenue Act of 1916, evidenced by the insertion of a new provision, section 13 (d).

Section 12 (a) of the Act of 1916, dealing with deductions, followed the same system as did the 1909 and 1913 Acts, allowing as deductions (1) ordinary expenses paid "within the year," (3) the amount of interest "paid within the year," and (4) taxes "paid within the year," the basis specified with respect to deductions, as well as gross income, being the receipts and disbursements basis.

Section 13 (d), however, introduced an alternative method and provided that if a corporation kept its accounts upon any basis other than that of actual receipts and disbursements it might, subject to regulations made by the Commissioner, make its return "upon the basis upon which its accounts are kept."

This allowed the taxpayer the option to make his return on a cash basis without regard to how he kept his books, or if he kept his books on some other basis to make his return upon the basis upon which his accounts were kept.

Montgomery's Income Tax Procedure, 1918, pp. 67–68, referring to the accrual system under the Revenue Act of 1916, says:

> Section 8 (g) of the law as applied to individuals, and Section 13 (d) as to corporations, provide for the return of

> "accrued" income as distinguished from "received."
>
> * * * * *
>
> The 1913 law was sadly lacking in correct phraseology, and no one, not even the framers of the law, knew whether income "received" or "accrued" was to be reported, or whether expenses "paid" or "incurred" or "accrued" were to be deducted.
>
> The law of September 8, 1916, cleared up all of these ambiguities and made it possible for the Commissioner of Internal Revenue to permit returns to be made which would accord exactly with the books of account of well-regulated concerns. The provision of the law referred to is quoted in T. D. 2433 * * *.

In connection with the accrual basis offered as an alternative by the 1916 Act, the Treasury Department, in T. D. 2433, issued January 8, 1917 (page 19 herein), approved of the practice of setting up and maintaining reserves to meet liabilities accrued but not yet due and including those the amount of which may not have been definitely determined.

The next shift was made in the 1918 Act (the Act of February 24, 1919, Chap, 18, 40 Stat. 1057). In Section 200 it was provided (40 Stat. 1059):

> The term "paid" for the purposes of deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred"

and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

Section 212 (b) provided (40 Stat. 1064):

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the the method of accounting regularly employed in keeping the books of such taxpayer * * *.

Section 222 (b) provided relative to credits for taxes (40 Stat. 1073):

> If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, etc.

Section 232 (40 Stat. 1077) provided that the returns of corporations should be on the same basis as those of individuals.

Section 238 (a), relating to credits for taxes in the case of corporate returns (40 Stat. 1080), contained the same provision as Section 222 (b) providing for readjustments in case the amount of taxes accrued upon the books differed from the amount ultimately paid.

These provisions of the 1918 Act deprived the taxpayer of the option he had under the 1916 Act of making his returns on a cash receipts and disbursements basis, or (if he kept his books on another basis) on the basis on which his books were kept, and limited the taxpayer to making his return on the basis on which his books were kept provided the basis tended to correctly show net income.

Although Section 12 (a) of the Act of 1916, dealing with deductions, provided for the deduction of "expenses *paid* within the year" and "losses actually sustained" within the year, and "interest *paid* within the year," thus providing for the deduction of all these items of expense in the year in which they were paid, placing the entire return on a receipts and disbursements basis, it can hardly be seriously disputed that Section 13 (d) provided for an alternative method permitting the taxpayer if he kept his books on an accrual basis to make his return on that basis, deducting expenses accrued within the year and interest accrued within the year and taxes accrued within the year. It is clear, too, that if the taxpayer used the accrual basis in keeping his accounts and made his return on that basis he could not be permitted to depart from the accrual basis in dealing with any item of expense.

II

In the present case the taxpayer kept its books on the accrual basis and made its return on that basis, and the munitions tax must be deducted in the year in which it accrued, as distinguished from the year in which it was paid

In the present case the appellee's income tax returns were not made on the receipts and disbursements basis.

It kept its books on an accrual basis and it elected to make its return and have its income-tax return computed on the basis on which its books were kept. In 1916, in the regular course of business, keeping its books on an accrual basis, the appellee deemed it proper to enter in its books of account for that year, as an accrued expense or liability, the estimated amount of the munitions tax for that year. It evidently considered that the consistent use of the accrual system required this treatment of the munitions tax and that the munitions tax was, in its nature, susceptible of being properly accrued upon its books as an expense for that year.

In making its income-tax return for 1916, although basing its return in other respects on its books of account, and making its return in other respects, both as to gross income and deductions, on the accrual basis, it attempted to make an exception of the munitions-tax item, and, instead of including it as an accrued expense for 1916 in the income-tax return for that year, omitted it entirely,

and a year later, in making its income-tax return for 1917, treated the 1916 munitions tax as a 1917 expense.

The appellee's position seems to be that, conceding that it kept its books on an accrual basis, and that, as a part of that system, it accrued the munitions tax in 1916 on its books for that year, nevertheless it was justified in departing from its books in making its return by eliminating the item of accrued munitions tax. If any justification for this exists, it must be that the munitions tax did not accrue in 1916 and was not susceptible of being accrued in 1916 under the accrual system of accounting, and this brings us to the ultimate question in the case.

III

Under the accrual system an expense accrues when all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The munitions tax for 1916 accrued in 1916, and the taxpayer made no mistake in entering the item on its books for that year as an accrued expense

The word "accrue" is used in different connections. Under statutes of limitation, a claim or cause of action is said to accrue when it becomes due and enforceable and an action may be immediately maintained. The word is sometimes used to indicate a liability which is due. Under the accrual system of accounting, however, income is said

to be accrued when it is definitely receivable, although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expense definitely incurred and income definitely earned without regard to whether payment has been made or whether payment is due. Income derived from the sale of merchandise in 1916 is properly accrued on the books for 1916, although payment may not be due until the following year. Expenses of any kind definitely incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year. Under this system, the use of the word "accrued" does not signify that the item is due. On the contrary, the accrual system wholly disregards due dates. Neither is it necessary that the amount of an incurred liability be accurately ascertainable in order to "accrue" it.

Excerpts from standard works on accounting on this subject are in the Appendix, p. 61.

The munitions tax for 1916 is based on the amount of munitions profits for that year; it was an actual expense or element of cost in the production of the income for that year; the law imposing the tax was in force during that year;

definite liability to pay the tax had arisen by the end of the year; every fact or circumstance affecting the amount of the tax had occurred by the end of the year, and no fact or event occurring after the end of the year was a factor in the computation or determination of the tax. By the close of the year, liability for the tax had become definitely fixed, the tax being based on the result of operations for 1916, which were closed December 31, 1916. Neither liability for the tax nor the amount properly payable could be affected under the law by anything occurring after December 31, 1916.

It is true the monthly estimates of the amount of the tax appearing in the monthly trial balances during the year 1916 were tentative and might vary up or down from month to month, and required final correction in closing the books for the year, but if the accounts of the corporation were correctly kept and its profits computed in the manner required by law, the amount of the munitions tax was definitely ascertainable at the end of the year. In this case the taxpayer knew the amount of the munitions tax at the close of the year when it entered the reserve on its books as well as it did when the return was made and the tax paid. The fact that a difference of opinion might arise after December 31, 1916, between the taxpayer and the Commissioner of Internal Revenue as to what was a reasonable depreciation on plant and equipment, or as to other items of that nature, did not provide

new factors occurring after December 31, 1916, varying the tax. Any other conclusion would mean that no such item could be properly accrued until the statute of limitations had run against the Government or the matter had been settled by a conclusive agreement between the taxpayer and the Government.

The accrual by the taxpayer of this tax on its books for 1916 was not only proper and in accordance with good accounting practice but was expressly approved by T. D. 2433, set forth above.

IV

Cases of United States v. Woodward, 256 U. S. 632, and Ed. Schuster & Company, Inc., v. Williams, 283 Fed. 115

The principal ground for the contention of the taxpayer that the munitions tax for 1916 did not accrue and could not be properly accrued on the books in 1916 is that the tax did not accrue until it was due, and the authority urged in support of this proposition is the case of *United States* v. *Woodward,* 256 U. S. 632. It is asserted that the *Woodward* case holds that no tax accrues, so that it may properly be accrued on the books of the taxpayer, until the tax is due, and therefore the accrual by the appellee of a munitions tax for 1916 on its books for that year was improper and the item was properly disregarded in making its return for that year, but was deductible in 1917 in calculating income for that year.

The *Woodward* case dealt with a Federal estate tax. Woodward died December 15, 1917. Under Section 204 of the Revenue Act of 1916 it was provided: "That the tax shall be due one year after the decedent's death." The tax was actually paid February 8, 1919. Two questions were involved: (1) Were the executors in making income-tax returns for the period of the administration of the estate entitled to deduct the Federal estate tax from gross income? And (2) if the deduction was proper, in what year should it be made?

The Court held that the tax accrued in 1918, because it was due in 1918, and that it was deductible in the income-tax return of the executors for that year. The main question dealt with was the deductibility of the Federal estate tax. The question as to the year in which the deduction could be taken was given scant consideration in the briefs.

The quotations from the Revenue Act of 1918 applicable to the *Woodward* case, found on pages 27–28 of this brief, show that in order to determine in the *Woodward* case whether the estate tax, if deductible, was deductible in the year in which it was paid, which was 1919, or in the year in which it accrued, which the Court held to be 1918, it was essential that the basis on which the executors kept their accounts should be disclosed.

Under the terms of the 1918 Act, the income-tax return was required to be made on the basis on which the books were kept. If that basis was a receipts and disbursements basis, it is plain that

in the *Woodward* case the estate tax would be deductible in 1919, the year in which it was paid, but if the books of the executors were kept on an accrual basis the estate tax would be deductible in the return for 1918 on the assumption that it accrued in that year.

Nowhere in the record or in the briefs in the Woodward case is any mention made of this subject, nor were the provisions of Sections 200, 212 (b) and 222 (b) of the 1918 Act referred to or called to the attention of the Court, and there was nothing in the record from which to determine on what basis the executors kept their accounts. This situation is mentioned to show that little attention was paid to the question of the year of the deduction in the presentation of that case, and that the accrual system of accounting, and the sense in which the word " accrue " is used in that system, were not considered.

Passing over this point, however, the Court did hold in the opinion that the Federal estate tax in the *Woodward* case accrued when it fell due under the terms of the statute, on December 15, 1918, and that it did not accrue December 15, 1917, when the decedent died, nor between that date and January 1, 1918.

In the Government's brief (of 48 pages) one page is given to the question as to when the estate tax accrued, stating merely that the law allowed the deduction of taxes paid or accrued within the taxable year; that the estate tax was a death duty;

that it accrued at the moment of death, and, consequently, accrued in 1917; that it was paid in 1919; that it therefore neither accrued nor was paid in 1918.

In the brief for the executors in the *Woodward* case, the only reference to this subject was as follows (p. 15):

> The decedent died December 15, 1917, and this tax was due and payable, or accrued, December 15, 1918, and was paid by the executors February 8, 1919.

All that the Court said on the subject was (p. 635):

> Here the estate tax not only "accrued," which means became due, during the taxable year of 1918, but it was paid before the income for that year was returned or required to be returned.

It is thus evident that in the presentation of the *Woodward* case the accrual system of accounting and the propriety of accruing items of expense under that system were not mentioned.

Nevertheless, we do not need to question the soundness of the conclusion reached in that case that the Federal estate tax accrued in 1918. The Court did not hold, however, that every tax, of every nature, and under every circumstance accrues on the date it falls due, and not before.

A radical difference between the circumstances affecting the accrual of a Federal estate tax and

those affecting the accrual of a munitions tax is obvious.

Section 203, Subdivision (a) (1), of the Revenue Act of 1916 (39 Stat. 778), applicable to the *Woodward* case and prescribing the method of determining the value of the net estate, provided for the deduction from the gross estate of—

> Such amounts for funeral expenses, administration expenses, * * * losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise, support during the settlement of the estate of those dependent upon the decedent, and such other charges against the estate, as are allowed by the laws of the jurisdiction, etc.

Woodward died December 15, 1917. It is obvious there were reasons for saying that the Federal estate tax could not properly be said to have accrued on December 15, 1917, or between that date and January 1, 1918. The provisions of Section 203 above quoted show that in the determination of the net estate, and therefore the amount of the tax, *various events subsequent to the date of the decedent's death and continuing through the period of administration were necessary factors in computing the amount of the tax.* There was not only no basis for accrual December 15, 1917, or prior to January 1, 1918, but an attempted accrual would

have been a mere speculation. The Court was right, therefore, in holding that the tax could not properly be said to have accrued between December 15, 1917, and January 1, 1918. The next step was to determine whether it accrued in 1918 or not until paid in 1919. By the terms of Section 204 it was expressly provided that the tax should be due December 15, 1918, and notwithstanding the same uncertain factors entering into the computation of the estate tax might continue to exist one year after the decedent's death, and indeed so long as the administration continued, nevertheless the statute required that the tax should be determined at the expiration of one year from the best information available and then be due, and no doubt the Court in the *Woodward* case would have found difficulty in holding that the tax had not accrued or was not accruable even though it was due. For the reasons stated and because of the allowable deductions from the gross estate on account of events occurring during the entire administration, an estate tax is in a class by itself. So long as administration continues and is not closed, events are occurring involving expenses of administration, losses from casualty, support of dependents, etc., which are continuing factors altering the amount of the tax. The tax can not be finally determined until the administration is closed, and yet it must be estimated and paid before the administration is closed. This peculiarity of estate taxes and inheri-

tance taxes has been recognized in the Revenue Act of 1924, in which, in Section 214, Subdivision (a) (3), relating to deductions allowed individuals in computing net taxable income and in authorizing a deduction of taxes paid or accrued within the taxable year, Congress adopted the rule with respect to estate taxes laid down in the *Woodward* case by providing (43 Stat. 270):

> For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes * * *.

The difference between the munitions tax of 1916 and a Federal estate tax is obvious. Every event constituting a factor in the ascertainment of the amount of the munitions tax had occurred at the close of business December 31, 1916. No business operation after that date could affect the amount of the tax. The factors constituting the basis for computation of the tax were all determined and known. The tax was an actual expense or element of cost in the production of income for 1916, and the fact that it was accruable and properly so under an accrual system of bookkeeping is evidenced by the act of the taxpayer in accruing it upon its books at the close of business for that year in order to fairly and honestly reflect the profits divisible to the stockholders. The liability under existing law had arisen at the close of business in 1916, and if the corporation had ceased to operate

at the close of 1916 its liability for the tax and the amount of the tax would not have varied or been affected.

Many kinds of taxes constitute an expense for the year in which they are levied—a contribution to the Government for the protection of the taxpayer's property during that year—and according to common practice accounts kept on an accrual basis properly include an accrual of such taxes at the close of the year in which and for which they are levied, although not due until the following year. To give to the statement in the *Woodward* case the effect claimed by the appellee, namely, that no tax is accruable or properly accrued until it is *due* would upset systems of accounting on an accrual basis on which current taxes for the year under consideration are commonly accrued. There is no more reason to hold that a tax like the munitions tax can not be accrued until it is due than there is to hold that interest can not be accrued until it is due. The tax has been irrevocably incurred, liability exists and is not contingent, and the events constituting the factors in the determination of the amount have happened. The real basis for determining whether a tax is properly accruable or accrued is whether the events have happened which fix liability. In the case of this munitions tax these events had happened by December 31, 1916. In the *Woodward* case they had not happened even at the time the tax was made due by the terms of the statute.

The other case referred to by the appellee with confidence is that of *Ed. Schuster & Co., Inc.*, v. *Williams*, 283 Fed. 115, a decision by the Circuit Court of Appeals for the Seventh Circuit. In that case it appeared that in 1919, effective October 10, 1919, an act was passed in Wisconsin known as the Soldiers Bonus Act, which provided for the raising of the entire bonus by one levy, which included a surtax over the normal tax upon the incomes of corporations upon the basis of their income-tax returns for 1918. The question in that case was whether, in determining the Federal income tax of the taxpayer, this State surtax was deductible from the income of 1918 or from the income of 1919. The taxpayer's returns were made on the accrual basis and its books were evidently kept on that basis, and it attempted, after the Bonus Act was passed, to revise its return for the previous year so as to "accrue" the bonus surtax as an expense of 1918, merely because the 1918 income was made the basis for the levy. The court was obviously right in holding that this could not be done. The bonus surtax had not been accrued upon the books of the corporation in 1918 for the obvious reason that the statute under which the tax was levied was not passed until October 10, 1919. At the close of business in 1918 no obligation had arisen under any existing statute for the payment of any such tax. What the legislature did was to impose the tax in 1919 under a statute passed in that year, and it merely adopted the net taxable income of the pre-

vious year as the basis for the tax. It might as well have chosen as a basis for the levy the average net income of five previous years or selected the net income of either 1915, 1916, or 1917 as a basis. There was at the close of business in December, 1918, manifestly no basis on which a tax not then imposed and arising under a law not then enacted could have been accrued under any system of accounting, and the fact that the legislature used the 1918 income as the basis for computing the tax did not make the tax a 1918 expense or one entering into the determination of the profits of 1918. The court makes this perfectly plain in its opinion holding that "there is no necessary relation between the basis for the levy, and the time of the accrual of the tax." In the present case we are dealing with a tax arising under a statute in force in 1916, creating a liability which existed at the close of business in December, 1916, and the amount of which was fixed and determined by events happening during 1916.

It is suggested that the shifting of the basis for income-tax returns from the cash receipts and disbursements basis to an accrual basis might operate in the process to prevent the taxpayer from receiving credit as a deduction for some items which were not deductible while the cash system was in effect because not actually paid, and could not be deducted when the accrual system was adopted because they had previously accrued. Such situations do arise where a shifting basis for income

taxes is adopted, and a corollary of the proposition is that some items of income which have been earned never have to be reported. Whether such a shift in the basis for the making of income-tax returns works to the advantage or disadvantage of any particular taxpayer does not render the statute invalid nor require its terms to be ignored.

The suggestion that the possibility that the munitions tax law in effect in 1916 might have been repealed before the tax became due prevented the tax from accruing in 1916 is plainly without merit.

An instruction which appeared on the form of income-tax return for 1916 is relied on by appellee as showing that the Treasury Department has not always been consistent in dealing with this subject, and there are some opinions by the Board of Tax Appeals in which it is said that a tax does not accrue until it is due—a statement evidently based on a misunderstanding of the *Woodward* case. The law is clear, however, and Treasury Decision 2433, issued in January, 1917, having the force of law, properly construed it. An able opinion of the Solicitor of Internal Revenue on the point, rendered in 1921, is printed as an Appendix to this brief.

CONCLUSION

It is submitted that as this taxpayer kept its books on an accrual basis, and elected to make its return on that basis, it should be required to adhere consistently to that basis, and not convert one

item from an accrual basis to a cash basis, transposing it from 1916 to 1917. The nature of the munitions tax was such that under an accrual system of accounting it was proper for the taxpayer to enter the item as an accrued expense in the form of a reserve for taxes upon its books for 1916, and it can not be successfully contended that the tax was of such a nature as not to be properly subject to accrual until 1917, and for these reasons the judgment should be reversed.

Respectfully submitted.

WILLIAM D. MITCHELL,
Solicitor General.
JOHN B. MILLIKEN,
Special Attorney,
Bureau of Internal Revenue.

OCTOBER, 1925.

APPENDIX A

CUMULATIVE BULLETIN NO. 4 (JANUARY–JUNE, 1921), BUREAU OF INTERNAL REVENUE, TREASURY DEPARTMENT, "INCOME TAX RULINGS," P. 147

SECTION 214(a) 3, ARTICLE 131:
Taxes. 10–21–1503
(Also Section 212, Article 23.) L. O. 1059

Corporation Income Tax—Revenue Act of 1916, section 12(a); section 13(d)

METHOD OF COMPUTING AND ACCOUNTING FOR MUNITION MANUFACTURER'S TAX WHEN TAXPAYER'S ACCOUNTS ARE KEPT ON THE ACCRUAL BASIS

Where a corporation in 1916 kept its accounts on the accrual basis, and either accrued munition taxes or credited amounts to a reserve set up to meet such taxes, thus taking advantage of section 13(d) of the Revenue Act of 1916, it became bound by the provisions of that section and Treasury Decision 2433, and the amounts so accrued or credited must, in computing income subject to tax for 1916, be deducted from gross income for that year, and not for 1917, during which year such munitions taxes were paid.

Section 13(d) of the Revenue Act of 1916 is a qualifying section, and when accounts of a corporation are kept on a basis other than that of receipts and disbursements it qualifies the manner of making deductions

authorized in section 12(a) of the Act, and the word "paid" in the latter section is to be read "paid or accrued," depending on how the accounts of the corporation are kept. [Syllabus.]

The question is presented whether the M Company, a corporation, considering the basis upon which its accounts are kept, is required, in computing its income tax for the calendar year 1916, to accrue munitions taxes assessed against the company under Title III of the Revenue Act of 1916, and deduct the amount thereof from gross income in its tax return for that year.

The company, in its tax return for 1916, made no deduction from gross income on account of munitions taxes assessed for that year, but claims the right to and did deduct the amount of such taxes in its tax return for 1917. This was in accordance with the consistent policy of the company, which has made it a practice since 1912 to deduct in its tax returns only the amount of taxes actually paid during the year for which the returns were rendered.

The munition manufacturer's tax is an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for the year 1916 from the sale or disposition of certain articles therein specified, manufactured in the United States.

In computing net income subject to tax under Part II of Title I of the Revenue Act of 1916, domestic corporations were allowed certain deductions from their gross income. Those deductions are enumerated in section 12(a) of the Act.

The provisions relating to general items of expense and taxes read as follows:

> SEC. 12(a). In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.
>
> * * * * *
>
> Fourth. Taxes paid within the year imposed by the authority of the United States, * * * or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits.

The proper treatment of the item munitions taxes for income-tax purposes depends not only upon the construction to be placed on the word "paid" as used in this section, but also upon the effect of section 13 (d) of the Act concerning the methods of keeping accounts, and Treasury Decision 2433.

Under revenue acts prior to the Revenue Act of 1916, the only recognized basis for keeping accounts was that of actual receipts and disbursements. Giving official recognition to the fact that it is the common practice for all large business enterprises

to keep their accounts on the accrual basis, this Department permitted the accrual of certain items of expense and the use of inventories. This practice was adopted to effectuate as nearly as possible, without doing violence to the language employed, the real purpose of those Acts, namely, to reflect the true income of the taxpayer upon which the tax was levied. However, taxes were not permitted to be accrued. They were deductible only in the year in which actually paid, and this remained the practice at least until the Revenue Act of 1916 became effective.

Section 13 (d) of the Revenue Act of 1916 is as follows:

> A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

This is the first time the law specifically recognized keeping accounts, for income-tax purposes, on any basis other than that of receipts and disbursements, and even then no other basis was to be used if the taxpayer's income thereunder was not clearly reflected, and in no event was another basis to be used unless it was in conformity with regulations made by the Commissioner with the approval of the Secretary. Formal consent in each individual case upon application made to making returns

of income on the basis upon which accounts were kept was not necessary. But there were two necessary requisites: First, the accounts must have clearly reflected true income; second, if a system other than receipts and disbursements were used, it must have been subject to regulations made by the Commissioner.

This Act was approved September 8, 1916, and shortly thereafter on January 8, 1917, Treasury Decision 2433 was approved by the Secretary. This Treasury decision, after quoting section 13(d) as above, reads as follows:

> Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.
>
> In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves

each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon

any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

The company contends, notwithstanding section 13(d) and Treasury Decision 2433, that the wording of the statute, "Taxes paid within the year" precludes their deduction in any year except that in which they were actually paid. If this be true, we have a peculiar and anomalous situation in connection with the company's returns. It admits, and its returns so show, that the ordinary and necessary expenses incurred within the year 1916 in the maintenance and operation of its business and property, provided for in the first subdivision of section 12(a), were accrued on its books and deducted in its tax return for 1916, whether or not such expenses were actually paid within that year. Likewise, all items of income, whether or not actually received, were accrued and included in gross income. So far as the statute is concerned, there is nothing to indicate that the expenses referred to in the first subdivision of section 12(a) should be accrued and deducted as accrued, and that taxes referred to in subdivision 4 thereof should be deducted only in the year

in which paid. The word "paid" is used in identically the same manner in both subdivisions without qualifying words, and according to rules of statutory construction the deductions classified thereunder must receive like treatment.

There would be great force to the argument that the wording of the statute "Taxes paid within the year" precludes their deduction in any year except that within which they are actually paid were it not for section 13(d). In construing a statute, full consideration must be given to all its provisions, and a construction adopted that will permit all sections to harmonize if possible. In framing the Revenue Act of 1916 it was contemplated, as theretofore, that accounts ordinarily were kept on the receipts and disbursements basis; hence the use of the word "paid" in connection with all items of deductions enumerated in section 12(a). But desiring to recognize other systems of keeping accounts, section 13(d) was inserted, which was designed especially to recognize the system of accrued accounting; that is, that all items of income and outgo be either actually determined or estimated as they accrue and that the proper entries be made upon the books at that time, returns of income be made on that basis, and the tax paid accordingly. To this extent, then, section 13 (d) is a qualifying section, and when accounts are kept on the accrual basis, so as to bring the taxpayer within this section, it qualifies the word "paid" and the manner of making deductions allowed in section 12(a). The word "paid," therefore, is to be read "paid or accrued," depending on how the accounts of the taxpayer are kept.

It is further contended by the company that it did not accrue munitions taxes, but only set up a reserve to meet this liability, the amount of which was not definitely determined until some time in 1917, and even if these taxes were accrued on its books it is still proper, in view of the wording of the statute, and the fact that Treasury Decision 2433 merely gives corporations permission to use the accrual basis and does not require it to deduct taxes only in the year in which paid. The company attempts to draw a fine distinction between accruals and reserves, the only difference being, so far as its brief shows, that a liability is accrued when the amount thereof is definitely ascertainable and a reserve is set up to meet a liability when the amount thereof can not be accurately determined. It also relies on articles 152, 156, and 158 of Regulations 33, promulgated January 5, 1914, as governing the method of computing and accounting for deductions of taxes for 1916.

From reports of the revenue agents, copies of actual book entries taken from the books of the company, and statements submitted by officers of the company, I am convinced the taxes in question were accrued on the books of the company. The statement furnished by the revenue agent starts with the year 1915, and sets up the distribution made by the N Company and followed for the remainder of the year by its successor, the M Company. In that year the company accrued income taxes. In July, 1916, the successor company began to set aside monthly amounts chargeable against the earnings of that year through "Undistributed Expense," these amounts being credited to the account "Federal Munitions Tax, 1916." That the

intention of the company was to accrue munitions taxes is shown by the explanations appearing on its books with reference to entries made in this account. The word "accrued" is used several times in specifying amounts accrued to certain dates. The balance sheets of the company reflect the liability for that year in item "Deferred Credits." The schedule of this account sets up the compilation, which includes income taxes for 1916, x dollars; munitions tax for 1916, $5x$ dollars; accrued expenses, $4x$ dollars; total, $10x$ dollars.

The method of keeping this account discloses that instead of a general reserve being set up as an extra safeguard to take care of a possible but unknown liability, the company accrued from month to month the estimated amount of munitions taxes it was required to pay and so constituted it a liability against the company's assets. This amount should not have been difficult to estimate, it being, as has been stated, twelve and one-half per centum of the net profits received during the year on the manufacture of certain products. Under the accounting method employed by the company it undoubtedly could estimate with great accuracy its probable profits from munitions operations, even though they could not be absolutely determined. While there may be a technical distinction in accounting between an accrual and a reserve, the setting up of a reserve is not inconsistent with the system of accrued accounting. Neither do I find anything in the law that distinguishes between them. The law looks only to whether the liability was actually incurred and does not prohibit the deduction of a proper reserve set-up to meet a known liability that is a proper deduction. Law Opinion

360. Therefore, the fact that the company failed to make an accurate estimate of its munitions taxes for 1916 is not sufficient reason for deducting the amount of such taxes in 1917. Few accrued liabilities are estimated with absolute accuracy, and it is generally necessary to make adjustments from time to time in these accounts as the situation requires. This fact is recognized in Treasury Decision 2433.

We come now to the question of the effect of this Treasury decision. It is unnecessary to enter into a discussion of whether under the language used therein corporations were merely given permission or were required to use the accrual system of keeping accounts. It is sufficient to note that this company not only kept its accounts on the accrual basis, accruing munitions and other taxes, but rendered its tax returns on that basis, with the one exception that taxes were deducted in the year in which paid. In this respect there was a departure from the established method of accounting not warranted by the law or regulations. Having elected to report its income subject to tax on the basis on which its accounts were kept, thus taking advantage of section 13(d), which brought it within the provisions of this section and Treasury Decision 2433, the company became bound by its election and, having decided to accrue income, it must go the whole way and accrue liabilities instead of accounting for them on a different basis, except where the Act specifically provides otherwise. Neither can it use one method in making one deduction and a totally different method in making another deduction. The reason for this is obvious. Take, for instance, the item under discussion. Munitions taxes are an

element of cost entering into every unit of production and which must be taken into consideration each year in computing net income subject to tax. It is an expense necessary to produce income, and income is improperly reflected if the deduction on this account is made the following year, as it is in no way related to the income of the latter year, and has the further effect of greatly inflating the income of the year to which it does relate. Such practice would be contrary to the provision contained in the first sentence of paragraph four of Treasury Decision 2433, which contemplates "that the *income and authorized deductions shall be computed and accounted for on the same basis* and that the same practice shall be consistently followed year after year," and to the provisions of section 13(d) which permit returns to be made on a basis other than that of receipts and disbursements only when income is properly reflected.

But whether the amounts set aside to cover munitions taxes were accrued or set up as a reserve should not, in my opinion, make any difference so far as this case is concerned. The Treasury decision referred to provides for deducting from gross income amounts credited to reserves each year to meet liabilities, the amount and date of payment of which are not definitely determined or determinable at the time the liability is incurred. As stated in Law Opinion 360:

> * * * With respect to a corporation making its return on an accrual basis, the crediting of an amount to a reserve to meet a given liability is equivalent to the payment of such liability by a corporation making its return on the basis of actual re-

> ceipts and expenditures, subject only to the requirement that, if such reserve is "in excess of the reasonable or probable needs of the corporation," amounts so credited shall be restored to income. *An amount credited to a reserve in 1916 is deducted, if at all, from income for the year 1916.* Whether or not it shall be deducted depends therefore upon the law in force in 1916. * * * The sole question is as to the character of the reserve and that it is to be determined by the law at the time when amounts are credited to it rather than by the law at the time when payments are made from it.

It would, therefore, appear that even though this is a reserve for munitions taxes it must be deducted from gross income in 1916 *or not at all.* See A. R. M. 26, page 115, and A. R. M. 29, page 119, Cumulative Bulletin No. 2, 1920.

Articles 152, 156, and 158 of Regulations 33 promulgated January 5, 1914, are not applicable. Those regulations were adopted in pursuance of the Act of October 3, 1913, which did not recognize the accrual method of accounting, and the articles in question could have no application in this case where advantage was taken of a new provision in a different Act, and in connection with which Treasury Decision 2433, which is inconsistent with those articles, was issued. For the same reason, the practice of the company established prior to 1916 of deducting taxes only in the year in which paid is not to be considered. What the company did in this respect prior to 1916, its 1916 return having been made under a new Act, has no bearing on the question here at

issue, as the question arose under the new and not the old Act, the Acts being dissimilar.

It is held that where a corporation in 1916 kept its accounts on the accrual basis, and either accrued munitions taxes or credited amounts to a reserve set up to meet such taxes, thus taking advantage of section 13 (d) of the Revenue Act of 1916, it became bound by the provisions of that section and Treasury Decision 2433, and the amounts so accrued or credited must, in computing income subject to tax for 1916, be deducted from gross income for that year, and not for 1917, during which year such munitions taxes were paid.

Section 13 (d) of the Revenue Act of 1916 is a qualifying section and when accounts of a corporation are kept on a basis other than that of receipts and disbursements, it qualifies the manner of making deductions authorized in section 12 (a) of the Act, and the word "paid" in the latter section is to be read "paid or accrued," depending on how the accounts of the corporation are kept.

CARL A. MAPES,
Solicitor of Internal Revenue.

APPENDIX B

In *Montgomery, Auditing Theory and Practice* (3rd Ed.) Vol. 1, pp. 495, 496, we find the following discussion:

> *The Accrual Method:* To be correct the income account for a given period must contain all of the earnings or revenue and all the expenses or costs applicable to that period. All transactions during the current period which apply to a previous period should have been included in that period, and all transactions which belong to the succeeding period or periods must be deferred. *In the former case, if proper reserves were set up for the items, no adjustment is necessary in the current period.* * * *
>
> *It is hardly possible that an accurate balance sheet or income account of any business can be prepared unless the accrual basis is adopted.* Concerns which close their books immediately after the end of a fiscal period almost always fail to include some items which belong to that period. *In practically all cases the omitted items are expenses, rather than earnings, so that the errors due to omission usually unduly increase the net income.* It is therefore important for an auditor to advise that books be left open long enough to ascertain the amount of liabilities which have been incurred but not discharged at the closing date. [Italics ours.]

Montgomery, Auditing Theory and Practice, 3rd Edition, Volume 1, pp. 239, 240, has the following to say relative to the accrual of taxes:

> *Taxes.*— * * * The federal tax accrues as of December 31 or at the end

> of the fiscal year, just as surely as any other item.
>
> The balance sheet of a commercial enterprise, prior to the enactment of the federal excess profits and federal and state income and franchise tax laws, rarely included a liability for accrued taxes unless real estate was owned. Under the laws mentioned taxes are imposed upon the net profits of corporations. This tax must be paid even if a corporation is dissolved before the end of the year for which the tax is imposed. Since the tax is specifically based on the net profits of a particular period, although payable some months thereafter, the tax accrues throughout such specific period; consequently, if a net profit is disclosed upon the closing of the books, an adequate reserve should be provided therefor.

Montgomery, in discussing the changed condition brought about by the Revenue Act of 1916, states the following with reference to the accrual of income and the failure to also accrue taxes:

> Under a provision of the law of September 8, 1916, an individual or corporation keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect the true net income, may, subject to regulations made by the Commissioner of Internal Revenue, make returns upon the basis upon which the accounts are kept.
>
> In accordance with this authority T. D. 2433 was issued January 8, 1917 * * *. All taxes accruing during a fiscal year or calendar year [with exceptions] may now be deducted in the return for the period during which the taxes accrue.

> *Those individuals and corporations which create reserves for taxes, for the proportion actually accrued, and which represent a charge against the income accrued, do so only because they desire to have their books reflect actual income. Frequently the accrued tax has a direct relation to income returned as accrued but not collected; therefore, it is as just to deduct one as to tax the other.* [Italics ours.] [*Montgomery, Income Tax Procedure,* 1918, pp. 305 and 306. See also pp. 67, 68, 241, 299 of the same edition.]

Esquerre, Applied Theory of Accounts, pp. 299–301, has the following to say relative to the cash basis and the accrual basis:

> *The Cash Basis.*—It may be that the policy of a concern is to keep its books on the "cash basis"; that is to say, to consider as income earned only that which has been received in cash, and that, correspondingly, only expenses paid in cash constitute income disbursed. This policy has the great disadvantage of not being consistent. It rests upon the possibility that the right to receive income may be lost by the failure of the debtor to pay what he owes, and upon the impossibility of enforcing payment when such contingency occurs. But if the basis is correct, it should apply also to accounts receivable recorded as a result of sales on credit, since the amount charged to customers contains not only the cost of the goods sold to them, but, as well, the profit realized on the sales. It is obvious that if it is sound theory to ignore income until it is received it is also sound theory to ignore the profit on sales until the customers have paid the indebted-

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ness which contains those profits. Yet it is doubtful whether a single instance could be found where a business concern which claims to be on a cash basis is consistent enough to apply that basis to merchandise transactions.

The Accrual Basis.—Many concerns keep their books on the "accrual basis." This method applies the accounting principle that the primary connection between the net assets and the net income derived therefrom, is a matter of earnings and of expense incurred, and not one of income received in cash and expenses paid in cash. It takes cognizance of the fact that unless income is recorded when earned, losses due to the failure to collect that income can not appear on financial statements.

* * * * *

Leaving expenses and liabilities out of the question for the time being, the adoption of the accrual basis means that, at the end of every accounting period, all income which has been earned during that period must be recorded as an accrued asset which, while perhaps not collected at the time, *because it is not due,* may be collected at some future time. This, of course, necessitates the recording of an income which will be credited to the profit and loss of the period, whether or not the accrued asset which it represents fails of collection. Thus, if the last interest receivable on investments in bonds of other companies or in bonds and mortgages or in loans on collateral, was received December 1, and the accounting period ends December 31, there has been earned interest for one month, which is an asset of the investor, as well as it is his income for the month of December.

Holmes, Federal Income Tax, 1917, pp. 299–301, in speaking of the Revenue Act of 1916, states the following with reference to accruals and reserves to meet liabilities:

> *Accruals.*—Corporations which accrue on their books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, may deduct from their gross income the amount so accrued, providing such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis, income from fixed and determinable sources accruing to the corporation is returned, for the purpose of the tax, on the same basis.
>
> *Reserves to meet liabilities.*—Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of the Interstate Commerce Commission, or of any federal, state, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, *the amount of which, and the date of payment or maturity of which is not definitely determined or determinable at at the time the liability is incurred,* the amount credited to such reserves may be deducted, provided the amounts deductible on account of the reserves approximate as nearly as can be determined the actual amounts which experience has demonstrated will be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves are made. If it is found that the amount credited to any such reserve is in excess of the reasonable or probable needs for which

the reserve was created, the excess will be disallowed as a deduction and restored to income for the purpose of the tax. In no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations be allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., are not allowed as deductions, since such losses are only deductible when definitely determined as a result of a closed or completed transaction and actually charged off. [Italics ours.]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1925.

No. 337.

THE UNITED STATES,
Appellant,

vs.

P. CHAUNCEY ANDERSON, *et al.*,
Appellees.

APPEAL FROM THE UNITED STATES COURT OF CLAIMS.

BRIEF FOR APPELLEES.

STETSON, JENNINGS, RUSSELL & DAVIS,
Attorneys for the Appellees,
15 Broad Street
New York, N. Y.

JOHN W. DAVIS,
FRANK S. BRIGHT,
MONTGOMERY B. ANGELL,
Of Counsel.

The Rumsey Press Law Publishing Office, Inc., 120 Nassau St., New York, N. Y.

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TABLE OF CASES.

STATUTES.

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THE UNITED STATES,
Appellant,

AGAINST

P. CHAUNCEY ANDERSON, *et al.*,
Appellees.

APPEAL FROM THE UNITED STATES COURT OF CLAIMS.

BRIEF FOR APPELLEES.

History of the Case.

This is an appeal taken by the United States from a decision of the United States Court of Claims awarding judgment to the appellees, the claimants below, in the sum of $19,749.55, as a refund for taxes erroneously assessed and collected by the Commissioner of Internal Revenue under the Revenue Act of 1916, as amended.

The petition was filed in the Court of Claims on February 28, 1923, followed by an amended petition filed on April 26, 1923. In the absence of demurrer, plea or answer to the petition, a statutory general traverse was duly entered under Rule 34 of the Court of Claims. The case was heard on an agreed statement of facts on December 9, 1924, and judgment for the complainants, in the sum noted above, was entered on January 5, 1925. The opinion of the Court of Claims is reported in 60 Ct. Cl. R., and appears on page 17 of the record herein.

Statement of Facts.

The appellees herein are the Trustees in dissolution of the Burton-Richards Company, a corporation in dissolution under the laws of the State of Delaware. The sum of $19,749.55, for which judgment in the court below was given, represented additional income taxes assessed and collected for the year 1917 under the provisions of the Revenue Act of 1916, as amended. These additional taxes were paid to the Collector of Internal Revenue at Cleveland, Ohio, under specific written protest, and upon the denial of a claim for refund duly filed with the Commissioner of Internal Revenue at Washington, the complainants immediately filed their suit.

The Burton-Richards Company during the year 1916 was engaged in the manufacture and sale of explosives, and in that year showed a taxable profit of $899,356.32 from such manufacture and sale. Under Title III of the Revenue Act of 1916 (39 Stat. L. 780), a so-called "Munition Manufacturer's Tax" of 12½% was imposed upon such net profits, making a total munitions tax for 1916 of $112,419.54. This munitions tax, while measured by the net profit shown in 1916, did not become due and payable until thirty days after assessment by the Commissioner of Internal Revenue and such assessment could not be made until after March 1, 1917, the date when the munitions tax return was due and filed.

The munitions tax return of the Burton-Richards Company for 1916, filed on March 1, 1917, showed a munitions tax due of $86,541.95. This amount was duly assessed by the Commissioner and paid on May 14, 1917. Thereafter, upon audit by the Commissioner, additional assessments were made aggregating $25,877.59, of which $21,510.09 was paid on September 6, 1917, and $4,367.50 on October 31, 1917. These additional assessments resulted from a reduction by half in depreciation taken in respect of buildings and machinery, and the addition to income of sundry items.

In addition to its munitions tax for 1916, the Burton-Richards Company early in 1917 filed its income tax return

for 1916 and paid income tax upon the net income as returned therein. In making out this income tax return for 1916, the 1916 munitions tax was not claimed as a deduction. In the year following, however, the corporation in accordance with the existing regulations of the Treasury took as a deduction in its 1917 return the total amount of $112,419.54 paid in 1917 as a munitions tax on account of its 1916 munitions profits.

In auditing the Burton-Richards income tax returns for the years 1916 and 1917, the Bureau of Internal Revenue at first acquiesced in the course adopted and permitted the taxpayer to deduct its 1916 munitions taxes in reaching net income subject to tax for the year 1917. Thereafter, to wit, on the 28th day of April, 1920, the corporation formally filed its certificate of dissolution with the proper authorities, and proceeded at once to distribute its assets to its stockholders.

Some two years after the dissolution of the company, the trustees in dissolution were surprised to receive a letter dated September 23, 1922, from the Revenue Agent in Charge at Cleveland advising the company that its 1916 munitions tax of $112,419.54, although paid in 1917, had been erroneously deducted in its 1917 return from its 1917 income and must be restored. Thereafter the Commissioner of Internal Revenue confirmed the Revenue Agent's position and on November 23, 1922, made an additional assessment against the Burton-Richards Company of $19,749.55. The amount was paid under protest (R. 9), a claim for refund was made and denied (R. 10, 11, 12) and this action followed.

The Question Presented.

The Statutes and Regulations involved are printed in the Appendix. The sole question presented is whether a corporate taxpayer may take as a deduction in its income tax return for the year 1917 a munitions tax measured by its net profits in 1916 but assessed, due and actually paid in 1917.

SUMMARY OF ARGUMENT.

I.

Under the Revenue Act of 1916, taxes may properly be taken as a deduction from income only in the year when paid, regardless of the character of the tax return made.

(a) *The administrative practice which had grown up under the prior Income Tax Acts clearly required that taxes be taken as a deduction only in the year when paid.*

(b) *Under the 1916 Act, only taxes actually paid within the year were deductible in determining taxable net income, whether the tax returns were made on the so-called cash basis under Sections 10 and 12(a), or under the alternative basis contemplated in Section 13(d).*

II.

The appellees' munitions tax for 1916 did not accrue until 1917, in which year it was assessed, became due and payable and was in fact paid, and consequently it was properly deducted from income of that year.

(a) *This court in U. S. v. Woodward, 256 U. S. 632, has definitely ruled that taxes accrue when they become due.*

(b) *The decision in the Woodward case governs the instant case.*

III.

The Burton-Richards Company made its returns for 1916 and 1917, not under the alternative provisions of Section 13(d), but under the provisions of Sections 10 and 12(a). That being the case, there can be no dispute that its 1916 munitions tax was deductible in 1917, the year when it was paid.

IV.

Conclusion.

ARGUMENT.

I.

Under the Revenue Act of 1916, taxes may properly be taken as a deduction from income only in the year when paid, regardless of the character of the return made.

The appellant in attempting to justify the position of the Commissioner of Internal Revenue in refusing to allow the Burton-Richards Company to take as a deduction from gross income in 1917 its 1916 munitions tax which was paid in 1917, relies upon the manner in which the Burton-Richards Company kept its accounts for the year 1916 and the basis upon which its income tax return for 1916 was made. It contends that in view of the manner of keeping accounts and making return the provisions of Section 13(*d*) of the 1916 Act not only permitted but required the Burton-Richards Company to take its 1916 munitions tax as a deduction in 1916 or not at all.

The Manner of Keeping the Books.

In keeping its books for the year 1916, the Burton-Richards Company took up on its books all items of gross income and general business expenses as and when such items became fixed and ascertainable in the form of accounts receivable and accounts payable regardless of whether the amounts shown were actually received or paid in cash. Interest was entered on its books during 1916 only as and when actually received or paid within the year. The Company's interest on its indebtedness was all paid in 1916, and so appeared on its books. No losses nor bad debts appeared in 1916, nor were any set up on its books during that year. The Company set up on its books month by month an arbitrary "reserve for taxes" of $35,000, as set forth in paragraph

5 of the Findings of Fact (R. 13). It did not pretend in so doing to be "accruing" the amount for income tax or other purposes. The service of such an entry was solely to reflect in conjunction with other entries the general financial condition of the Company as a going concern and to guide it in the declaration of dividends or the making of other disbursements.

The Method of Making Returns.

The original and amended income tax returns of the Burton-Richards Company for 1916 and 1917 were made a part of the stipulation of facts in the court below. In these returns there was included as gross income all items arising from sales made within the year whether paid or payable in cash, while the company took as deductions:

(*a*) General expense, whether paid in 1916 or not;

(*b*) Depreciation charged off;

(*c*) Interest paid; and

(*d*) Taxes, domestic, paid.

As a result of this method of keeping its accounts and making its return for 1916, the appellant maintains that the return must be taken to have been made on what it terms "the accrual basis", as distinguished from a return made on "the cash basis", and as the Company's 1916 munitions tax "was accrued" in 1916, it must be taken as a deduction in 1916.

Historical Survey.

Throughout the Government's brief much is said of "the cash basis" and "the accrual basis" of making income tax returns, the inference being that these two methods of making return are exclusive and mutually independent. The fact is that these two terms are not self-explanatory, but require

clarification. Before proceeding with the argument it may be of some service to outline briefly the structure of the earlier Income Tax Acts and the administrative procedure which grew up under them, in order that the Court may have before it the situation as it existed on the enactment of the 1916 Revenue Act.

(a) *The administrative practice which had grown up under the prior income tax acts clearly required that taxes be taken as a deduction only in the year when paid.*

In the earlier Income Tax Acts Congress did not make what is commonly known as "commercial net income" the basis for the tax levy. That which is subject to tax under these several Acts is "net income", and in every case "net income" is ascertained by deducting from gross income certain arbitrary deductions. In the first of the so-called Income Tax Acts, namely, the Excise Tax Act of 1909, the net income subject to tax was determined by deducting from the gross amount of income "received within the year":

(1) The ordinary and necessary expenses "actually paid within the year",

(2) "losses actually sustained within the year",

(3) "Interest actually paid within the year", and

(4) "Sums paid by it within the year for taxes".

Thus the gross income which was taken as the starting point was the gross income "received", and the several deductions allowed were ordinary and necessary expenses "actually paid", losses "actually sustained", interest "actually paid", and taxes "paid."

Obviously, a literal interpretation of the 1909 Act demanded a strict and thorough going cash basis for making return and paying tax. Yet, from the first, the Treasury Department, in its formal regulations issued under the 1909 Act, not only permitted but required a departure from a strict cash basis. In Article 5, Regulations 31, issued under the 1909 Act, inventories were not only permitted

to be taken but they were said to be "essential" in the proper preparation of a corporate return; while in Article 4 of the same Regulations, in speaking of deductions it was stated "it is immaterial whether the deductions are evidenced by actual disbursements in cash or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so interpreted on the books *as to constitute a liability against the assets of the corporation.*" (Italics ours.) But T. D. 1742, which constituted paragraph 77 of Regulations 31, specifically provided that reserves for taxes could not be allowed, as in the words of the Regulation, "the law specifically provides that only such sums as *are paid* within the year for taxes can be deducted". (The words "are paid" are italicized in the official text.)

With these formal regulations issued by the Treasury Department before it, Congress, in passing the 1913 Revenue Act, employed substantially the same phraseology as to gross income, business expenses, losses, interest and taxes as it had employed in the 1909 Act. Following the passage of this Act the Treasury Department in its formal regulations (Regulations 33, issued Jan. 5, 1914) defined gross income in Article 104 thereof as "the total sales of manufactured goods during the year," required the use of inventories and specifically provided in Article 158 regarding deductions that "it is immaterial whether the deductions, except for taxes and losses, are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return." But, in the same Article, the deduction for taxes was limited to amounts "actually paid" within the year, and Article 156 specifically provided that "reserves for taxes cannot be allowed".

There is attached hereto as Appendix "A" a comparative statement setting forth the relative provisions of the 1909, 1913 and 1916 Acts regarding the respective methods prescribed for arriving at taxable net income, and as Appendix "B" the pertinent parts of the respective Treasury Regulations issued under those Acts.

This interpretation of the phrases "gross income received" and "ordinary expenses paid" was essential to any reasonable interpretation of the two Acts. The enforcement of a literal cash receipts and disbursements basis, so far as gross income and business expenses are concerned, would have been impossible in the case of corporations engaged in manufacture, and if insisted upon would have resulted in returns and taxes thoroughly at variance with the true state of affairs. But while departure from the strict cash basis was both permitted and required in fixing gross income and business expenses, when it came to taxes, the Treasury, as noted above, invariably permitted them to be taken as deductions only in the year when "actually paid".

Thus, the basis employed in making returns under the 1909 and 1913 Acts, though commonly referred to as the *cash* or *receipts and disbursements* basis, was in point of fact a basis which took into income accounts receivable as well as received in cash, and permitted as deductions for the ordinary and necessary business expenses amounts payable although not actually paid in cash. But taxes were permitted as a deduction only in the year in which the taxes were in fact paid.

The 1916 Act and Regulations Issued Thereunder.

Having before it the Treasury regulations issued under the 1909 and 1913 Acts, Congress framed and enacted the Revenue Act of 1916. Reference to the comparative statement in Appendix "A" attached hereto shows that the 1916 Act employed the same phraseology as the earlier Acts had used in defining net income subject to tax, that is, gross income, the starting point, was income "received within the year", and in reaching taxable income the deductions allowed were: first, the ordinary and necessary expenses "paid within the year"; second, "losses actually sustained"; third, "interest paid within the year"; fourth, "taxes paid within the year".

The Treasury Department in its regulations under the 1916 Act, namely Regulations 33 (Revised), as in the prior regulations under the 1909 and 1913 Acts, defined gross income as "the total sales * * * during the year" (Article 91), required that inventories "must be taken where the business consists of buying and selling commercial commodities" (Article 120), and in Article 126, in defining the word "paid" it was flatly stated: "If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash, provided it is so entered on the books of the company as to constitute a liability against its assets". But again, so far as taxes were concerned, Regulations 33 (Revised), in Article 191 thereof, permitted as a deduction for taxes only such taxes as were "paid within the year".

It is evident from the foregoing that the so-called cash or receipts and disbursements basis used under the 1909 and 1913 Acts and recognized at least for a time under the 1916 Act, was not and never had been a literal cash basis. It was in reality a mongrel basis which had taken shape on account of the very necessities of the case and which after adoption had received Congressional sanction by the subsequent re-enactment of similar provisions of law. More properly it should be termed the *statutory* cash basis rather than *the* cash basis, a term which obviously is a misnomer. This statutory cash basis was consistently recognized and employed by the Treasury Department in administering the several income tax acts until the issuance in January, 1921, of the opinion of the Solicitor of Internal Revenue known as L. O. 1059 (see Cumulative Bulletin 4, p. 147), the opinion upon which the Commissioner acted in disallowing the deduction for taxes and which gave rise to the instant case, an opinion which constituted an entire reversal of the Treasury's prior practice in treating the deduction for taxes.

(b) *Under the 1916 Act only taxes actually paid within the year were deductible in determining taxable net income, whether the tax returns were made on the so-called cash basis under Sections 10 and 12(a), or under the alternative basis contemplated in Section 13(d).*

With the previous history in mind, we come to a consideration of the 1916 Act. It is the contention of the appellees, as we point out hereafter, that the Burton-Richards Company's 1916 and 1917 returns were made on the statutory cash basis under Sections 10 and 12(*a*), thus removing any possible doubt as to the right to deduct taxes paid within the year. Passing over this point for the moment, it is submitted that whether the basis used was the cash basis or the basis contemplated by Section 13 (*d*), only taxes actually paid within the year could be taken as deductions in determining the taxable income for that year.

By the express provisions of the 1916 Act, that which is subject to tax is "net income", and "net income" must be determined by deducting from "the gross amount of its income received within the year" certain arbitrary deductions. One of these deductions, among others, is "taxes paid within the year imposed by the authority of the United States or its territories". This is a clear, unequivocal provision of law, a provision so clear and unequivocal that neither the tax payer nor the Commissioner in administering the Act can depart from its plain import without very clear ground for interpreting the word otherwise.

On the contrary, all indications are that Congress intended to limit the deduction for taxes in any particular year to an amount not exceeding that actually paid within the year. The Excise Tax Law of 1909 and the Income Tax Act of 1913, as well as the Regulations issued thereunder, were perfectly clear in this regard, and as stated above it was the uniform practice of the Commissioner of Internal Revenue under those Acts not only to permit but to require the deduction of taxes only for the year in which such taxes were in fact paid. Thus, at least until the passage of the

1916 Act, the law, the regulations and the administrative practice in the Bureau were uniform in this regard.

When enacting the 1916 Act, Congress again employed the word "paid", and "paid" alone, in describing the allowable deductions for taxes. The re-enactment by Congress of provisions similar to those employed in an earlier Act which had received a certain construction by the Executive Department charged with the administration of the Act "amounts to an implied recognition and approval of the executive construction of a statute." *National Lead Co.* v. *U. S.*, 252 U. S. 140. Whatever may be the effect of the appearance of Section 13(*d*) in the 1916 Act, there is no warrant in law for imputing to Congress an intent to permit or require the deduction of taxes in any taxable period other than that in which such taxes were actually paid.

"Paid" Does Not Mean "Paid or Accrued".

That Congress was familiar with the word "accrued" is evidenced by the phraseology used in the Munitions Tax law, which was Title III of the Revenue Act of 1916. In Section 302 of that title it was provided that in computing the net profit there shall be allowed as deductions "from the gross amount received *or accrued* for the taxable year * * * the following items". (Italics ours.) Had Congress intended the word "paid" in Section 12(*a*) of the 1916 Act to mean "paid or accrued", it would have said so. In the relative provision of the 1918 Act, namely, Section 234(*a*) (3), Congress did say so, for that Act permitted the deduction of taxes "paid or accrued within the taxable year". To permit or acquire under the 1916 Act the deduction of taxes when accrued rather than when paid would be to impute to Congress an intent in enacting the 1916 Act to which it first gave expression in the 1918 Act. This is not to be done. *Shwab* v. *Doyle*, 258 U. S. 529, 536.

In the case of *Brilliant Coal Co.* v. *U. S.*, 59 Ct. Cl., 481, it appears that the Commissioner of Internal Revenue attempted to do in regard to interest exactly what here has been

attempted in regard to taxes. In a well considered opinion, the Court of Claims ruled that the 1916 Act in using the phrase "interest paid" meant interest paid and not interest accrued, and allowed the Brilliant Coal Co. to recover the additional tax which it had been compelled to pay on account of the Commissioner's unwarranted interpretation. Appeal was taken from the Court of Claims' decision, but when the appeal came on to be heard it was dismissed on the motion of the Solicitor General. Certainly, if the position taken by the Commissioner is not maintainable in regard to interest, it is even more infirm in regard to taxes. The argument (which is set forth in L. O. 1059 attached to appellant's brief in this Case) that Section 13(*d*) qualifies the manner of making deductions authorized in Section 12(*a*) of the Act so that the word "paid" in Section 12(*a*) is to be read "paid or accrued" is without foundation.

The Government's Position.

It is not clear from the Government's brief whether its present position is that taken by the Solicitor of Internal Revenue in L. O. 1059, or whether it has now abandoned that position and undertakes to justify the requirement that taxes be taken in a year other than the year when paid on the ground that Section 13(*d*) in and of itself sets up a separate method of arriving at net taxable income quite distinct from that prescribed in Sections 10 and 12(*a*) of the Act; for in its brief, on page 29, it describes Section 13(*d*) as providing "an alternative method permitting a taxpayer if he kept his books on an accrual basis to make his return on that basis", and further contends that "if the taxpayer used the accrual basis in keeping his account and made his return on that basis, he cannot be permitted to depart from the accrual basis in dealing with any item of expense".

The proposition that Section 13(*d*) sets up a separate and distinct method of reaching taxable income is a strain upon its language, quite aside from the fact that its very position in the Act as a minor section can hardly justify giving it such dignity. The argument seems to be that Section 13(*d*),

in setting up the basis upon which the accounts are kept, contemplates a thorough-going return on the accounts basis, and that if the return is made on the accounts basis, every deductible item, including interest and taxes as well as business expenses, must be taken on the basis of the accounts. But obviously Congress did not contemplate that a taxpayer, regardless of the limitations imposed in Section 12(*a*) upon the extent of the deductions for interest and taxes authorized, might, nevertheless, take as a deduction an amount of interest or taxes merely by the simple device of setting up on its books a reserve for interest or taxes. Such a construction would put it in the power of the taxpayer to take as a deduction from net income an amount of taxes or interest which Congress said specifically in Section 12(*a*) could not be so taken.

For example, in 1917 Congress, by amendment to Section 12(*a*) of the 1916 Act, withdrew its grant of right to deduct Federal income and excess profits taxes. Suppose a taxpayer in 1917, keeping his accounts on what the appellant chooses to call the accrual basis, set up a reserve on its books for income and profits taxes and expressly made return under Section 13(*d*), claiming such reserve as a deduction. If the limitations contained in Section 12(*a*) do not limit the extent of the deductions which may be taken under the basis authorized in Section 13(*d*), then in 1917 the Commissioner, under appropriate regulations, might have authorized the deduction of income and excess profits taxes, even though Congress had expressly prohibited such a deduction. To assign to a subordinate section of a Revenue Act an interpretation susceptible of such a far reaching result is obviously unsound.

It is arguable that Section 13(*d*) to a limited extent contemplated the so-called "accrual" system of accounting and that Congress by inserting that section in the 1916 Act intended to give express recognition and legislative sanction to the practice which had grown up under the earlier Acts by administrative regulation of permitting and even re-

quiring the use of accounts receivable in determining gross income, and accounts payable in reaching deductible business expenses. In fact, it may be that the insertion of Section 13(*d*) in the 1916 Act foreshadowed the decision of this Court in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, in the sense that it was an express recognition by Congress of the necessity of subtracting from gross income the cost of earning gross income in reaching that "income" which alone is taxable under the Constitution. But it is hardly conceivable that Section 13(*d*) authorized deductions for such items as taxes and interest without regard to the specific limitations placed on such deductions in Section 12(*a*). It is true that the right to employ Section 13(*d*) is made subject to regulations issued by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, but an interpretation of Section 13(*d*) which would permit, under appropriate regulation, deductions for interest and taxes other than those specified in Section 12(*a*) would vest in the Executive branch of the Government a discretion clearly not intended, and one which would perhaps amount to an unconstitutional delegation of authority.

The True Function of Section 13(*d*).

The fact is that Section 13(*d*) was not a recognition of the so-called accrual system of accounting as the Treasury would have us believe, but contemplated a great variety of methods of accounting. The words "accrue" or "accrual" are nowhere used in the law. It is respectfully submitted that Section 13(*d*) represented the first step by Congress, though a cautious one, toward a recognition of the principle that there are a number of corporations, which, on account of the nature of the business in which they are engaged, employ a variety of accounting methods not adapted to making returns upon the so-called statutory cash basis, and that in such cases a return on the basis upon which the accounts are kept will more clearly reflect income than a return on the

statutory cash basis. For instance, take a corporation engaged on a large scale in coal mining or in ship building. In the case of the mining corporation good accounting would permit the writing off yearly on the books as current expenses of a large and varied number of items such as mine cars, underground trackage extensions, hoistways, and rock tunnels drilled to reach new coal. Or, such current items might with equal propriety be carried on the books to capital and depreciated yearly. In such a case, Section 13(*d*) would permit the taxpayer to make his return and pay income tax in accordance with the way his accounts are kept, provided that such return with a fair degree of accuracy reflects his income.

Again, consider a ship-building company where the product made requires two or more years to complete. Such a corporation may either enter on its books annually as income a proportional amount of the anticipated profits from the sale of the article or it may take up the entire profit as income in the year when realized. Similarly, it may with propriety treat expenses in building a ship as applicable to different tax periods in accordance with the method of accounting which it employs. Here again Section 13(*d*) would permit the taxpayer to make his return upon the basis on which its accounts were kept and take up as income on its return items of income as shown on its books, provided that the return so made reflected its income with a real degree of accuracy.

In none of these special cases, however, may such items as losses, interest and taxes be taken as deductions except as permitted in Section 12(*a*).

The Regulations Issued Under Section 13(d) Preclude the Deduction of the 1916 Munitions Tax in 1916.

The right to make a return under Section 13(*d*), moreover, was by the very terms of that Section "subject to regulations made by the Commissioner". The contemporaneous

regulation made by the Commissioner covering 13(*d*) was T. D. 2433. This provided for the deductions of certain reserves from income, if those reserves were set up on the books of the taxpayer.

In the last paragraph of this regulation its application is limited by the following provision:

> "The reserves contemplated by the foregoing rule are those reserves only which are set up to meet some *actual liability incurred,* the amount necessary to discharge which cannot at the time be definitely determined." (Italics ours).

This language leaves the reserve for taxes established by this taxpayer outside the bounds of the Treasury Decision, since the munitions tax here involved was not an actual liability at December 31st, 1916. Taxes constitute a liability only when they become due or at the earliest when they are assessed.

> *Lane County* v. *Oregon,* 7 Wallace, 71;
> *Meriwether* v. *Garrett,* 102 U. S. 472, 513.

That T. D. 2433 was not intended to permit taxpayers to deduct reserves for taxes is indicated not only by the contemporaneous action of the Commissioner, but also by the specific provisions of T. D. 2490, issued January 2, 1918, nearly a year after T. D. 2433, under which Treasury Decision taxes deductible were without qualification described as "taxes paid within the year".

II.

The appellees' munitions tax for 1916 did not accrue until 1917, in which year it was first assessed, became due and payable, and was in fact paid, and consequently it was properly deducted from income for that year.

The tax in the instant case was formally assessed and became due in the year 1917. It certainly could not accrue at any earlier date. *United States* v. *Woodward*, 256 U. S. 632, *Clapp* v. *Mason*, 94 U. S. 589; *Mason* v. *Sargent*, 104 U. S. 689; *Sturges* v. *United States*, 117 U. S. 363.

In the course of its opinion in the *Woodward* case, the court said:

> "Here the estate tax not only 'accrued', which means became due, during the taxable year 1918, but it was paid before the income for that year was returned or required to be returned. When the return was made the executors claimed a deduction by reason of that tax. We hold that under the terms of the Act of 1918 the deduction should have been allowed."

True, the *Woodward* case was a case involving the estate tax, while the tax here in question is a so-called munitions tax. But surely the rule as to when a tax accrues must be uniform without regard to the nature of the tax, for uniformity in taxing statutes will be presumed unless there are clear reasons for a difference in treatment.

But the Government seeks to avoid the decision in the *Woodward* case, if not to obtain a reversal of the principle therein established.

The Government's Interpretation of the Phrase "Taxes Accrued."

In its discussion of the question, the appellant wavers between two interpretations of the phrase "taxes accrued", one interpretation being taxes which have accrued, the other,

taxes which have been, or perhaps rather should have been, accrued. The first phrase is one, in the interpretation of which aid can be derived from the general dictionaries, from legal dictionaries and legal decisions. The phrase "taxes which have been accrued" is not susceptible of such interpretation, since no transitive use of the word "accrue" is recognized in dictionaries, either legal or general, or in any court decisions with which we are familiar.

In this connection it is interesting to observe that throughout its discussion the appellant cites no legal authorities in support of its position. The interpretation of the phrase "taxes which have been accrued" has to be deduced mainly from the context in the appellant's brief. It apparently means taxes which have been or should have been taken up on the books of the company, the bookkeeper being in this case an active agent who "accrues" the tax, instead of the tax itself accruing in the due course of events as it does in the more customary concept.

As between these two alternative interpretations, the appellant seems at times to lean towards the meaning taxes which have accrued, possibly thinking that in doing so it can derive some support from the subsequent allowance of taxes accrued as a deduction under the 1918 Act. At other times, it seems to lean towards the interpretation taxes which have been accrued, apparently because this interpretation brings its contentions more nearly in accordance with the provisions of Section 13(*d*) of the 1916 Act, which provides for returns being made under certain circumstances on the basis on which the accounts of the taxpayer are kept. It must, however, stand or fall on one interpretation or the other. It cannot shift from one to the other as expediency may seem to make a shift desirable.

Valuable light is thrown on this point by the appellant's action in case No. 420, in which its main argument on this question is presented. The glaring inconsistencies resulting from the appellant's theory in that case will no doubt be presented in the appellee's brief. The facts therein are

here referred to only to interpret the appellant's use of the word "accrued."

From the findings in that case it appears that in 1916 the taxpayer actually paid and took as a deduction in its return taxes amounting to $85,758.75, that it set up or "accrued" on its books in that year a reserve for taxes amounting to $449,312.33, of which $247,763.19 was for munitions tax. It further appears that the amount of taxes paid in 1917, which the Commissioner has now thrown back into 1916, was only $255,696.73, being the precise amount of munitions tax paid in 1917. This amount added to taxes paid in 1916 makes a total of only $341,455.48, or some $108,000 less than the amount "accrued" on its books by the taxpayer at December 31, 1916. In part, this difference doubtless consisted of income taxes on 1916 income payable in 1917.

The following important facts immediately become apparent:

First, that the Commissioner has not adjusted the return for 1916 in respect of taxes to "the basis on which the accounts of the taxpayer were kept", seeing that the basis on which the books were kept called for the "accrual" of taxes amounting to $449,312.33, while the Commissioner has allowed as a deduction not more than $341,455.48.

Second, that the tax treated by the Commissioner as having "accrued" at December 31, 1916, is not measured by the reasonable estimate of such tax made by the taxpayer at December 31, 1916, of $247,763.19 but by full amount of the tax subsequently ascertained to be payable, on $255,696.73.

Third, that the Commissioner has not allowed the taxpayer as a deduction in 1916 the income tax on its income for 1916, though consistency would require that it should be so allowed equally with the munitions tax.

In other words, the Commissioner has immediately fallen into inconsistency in applying his own rule and is, moreover, attempting to tax appellee by first holding that it must make its return on the basis of accruals, using "accrued" in one sense and then in computing the taxpayer's allowable deduc-

tions, interpreting the word "accrue" in a totally different and inconsistent sense.

It is, therefore, fairly inferable that when forced to an election the appellant elects to take its stand on the interpretation of taxes accrued as meaning taxes that have in law accrued. This being so, a large part of the discussion and the references to accounting authorities on the question how and when taxes ought to be accrued in books kept on an accrual basis become irrelevant and we, therefore, do not propose to discuss them.

The Government's Suggested Rule as to the Time When a Tax Accrues.

The appellant's contention is that a tax has accrued when the last event happens by which the liability of the taxpayer is determined, even though the determination of the tax is not made until a subsequent date. Upon this theory it urges that the munitions tax involved should be considered as having accrued in the last moment of 1916.

Attempted Distinction of the Woodward Case.

It seeks to distinguish this case from the *Woodward* case on the ground that the tax to which that case applied was an estate tax which might in some cases depend on events happening after the date at which it became due, and by conceding that in such an event the tax accrues at the time when it becomes due. More accurately stated then, its position is that a tax accrues *either* when the last event which determines the amount of the tax happens *or* when it becomes due, whichever occurs first. Such a rule is obviously lacking in one of the prime requirements of a satisfactory rule for such purposes, that of uniformity.

If the appellant's rule were accepted it would follow that the income tax for 1916 accrued in that year just as much as did the munitions tax. This would mean that the

income tax would have to be deducted, in arriving at the sum on which that tax was to be computed, a procedure which it is highly improbable that Congress intended, and which the findings in Case 420 show the Commissioner has not in fact adopted in practice.

It is easy to see how still more complicated algebraic computations might be required by the application of the appellant's method. If, for instance, taxes were deductible in computing the munitions tax in the same way as in computing income tax, we should have the position that the munitions tax and the income tax would both be deductible in determining the amount on which each was to be computed, and we should thus have precisely that case of two mutually dependent indeterminates on which this Court commented in the case of *Edwards* v. *Slocum,* 264 U. S. 61, 62, where it was said:

> "The Government offers an algebraic formula by which it would solve the problems raised by two mutually dependent indeterminates. It fairly might be answered, as said by the Circuit Court of Appeals, that 'algebraic formulæ are not lightly to be imputed to legislators', but it appears to us that the structure of the statute is sufficient to exclude the imputation. As further remarked below, the theory departs from the long established practice of the law not to regard the incidence of a tax in the levying of a tax * * *".

The very impracticability of the appellant's rule as applied to conditions which are peculiarly liable to arise under a dual system of Federal and State taxation is sufficient to refute its soundness.

The appellant, however, utterly fails to estabish its distinction. Its contention is as follows (p. 40 of appellant's brief):

> "The difference between the munitions tax of 1916 and the Federal estate tax is obvious. Every event constituting a factor in the ascertainment of the amount of munitions tax had occurred at the close of business

December 31, 1916. No business operation after that date could affect the amount of the tax. The factors constituting the basis for computation of the tax were all determined and known."

A single illustration will show the inaccuracy of these contentions. One of the most important elements in the determination of the munitions tax was the deduction to be allowed for amortization which was to be determined by the Commissioner under the following general provisions of the Act: "A reasonable allowance according to the conditions peculiar to each concern for the amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants."

In the computation of such amortization, one of the most important elements was the duration of the war. Will the appellant suggest that the allowance for amortization was not affected by the entry of the United States into the war on April 6, 1917, or the fact that the war ended on November 11, 1918, rather than April 6, 1917, or any other date? Will the appellant suggest that the entry by a taxpayer into a contract for munitions on January 1, 1917, would not affect the reasonable allowance for amortization of equipment theretofore employed in the manufacture of similar munitions? Will the appellant suggest that the facts constituting the basis for the computation of the tax were all determined and known when on December 31, 1916, it was not even determined what were munitions and what were parts of munitions, within the meaning of the Act? Controversies on these questions continued for years and some remain still unsettled. The fact is that the uncertainty attending the computation of the munitions tax in 1916 which could only be resolved by future events, were at least as many and as great as in the case of the ordinary estate tax. Moreover, there was always the possibility that the law would be changed before the tax became due, a possibility which approached more nearly to probability, as the United States drew nearer to war in the early days of 1917. It is

true that while the general structure of income taxation was twice changed during the year 1917, this particular provision was not disturbed. It will be recalled, however, that the tax for the taxable year 1918 was changed between the close of the year and the date when the tax became due. Similarly, the law was changed in 1924 in relation to the taxation of 1923, and another similar change is foreshadowed for the year now current. In some cases munitions taxes have not even yet been determined by the Commissioner, although it is nearly eight years since the law ceased to have any effect. Yet, according to the appellant's theory and consistently with its action in Case 420, these taxes when finally determined will be deemed to have accrued in the years 1916 or 1917.

There is No Analogy Between Taxes and Expenses.

The appellant appears to regard the treatment of taxes accruing before they are assessed or become due as justified on the analogy of its treatment of business expenses as accruing before the date when they become payable. The unsoundness of such an analogy is readily apparent. Business expense cannot be said to accrue until a legal liability therefor has been created. There was no legal liability for the munitions taxes in question until they were assessed and became due. Until that time there was always the possibility that they might never become liabilities through the repeal or change in the taxing statute. On this general question, the language of the court in *Meriwether* v. *Garrett,* 102 U. S. 472, 513, is apposite, and taken with the decision in the *Woodward* case is, we think, conclusive of the issue.

The Accounting Authorities Do Not Support the Appellant.

The appellant cites accounting authorities for the proposition which it advances as to when taxes accrue, but these authorities do not support the position the appellant has taken. Montgomery in the passage cited by the appellant speaks of the tax as "accruing throughout

the year", which is an essentially different theory from the appellant's that the tax accrues at the last moment of the year. All the arguments based on accounting practice and commercial convenience which the appellant seeks to take advantage of are wholly inapplicable to its present contentions.

It may also be pointed out that the *Woodward* decision rests on a sound economic basis in that whatever may be the basis or the *measure* of taxes, taxes are essentially contributions to the cost of government and as the law contemplates that the taxes will be paid when due, they are properly to be regarded as contributions to the expenses of the government in the period in which they become due, and therefore as charges or expenses applicable to that period. As the Court said in *Schuster* v. *Williams* (C. C. A., 7th Circuit, 1922), 283 Fed. 115, 116:

> "There is no necessary relation between the basis for the levy and the time of accrual of the tax."

The rule that taxes accrue when they become due and payable, the rule announced by the court in the *Woodward* case, is a rule simple of understanding, economically sound, concise in terms and readily capable of uniform application without regard to the nature of the particular tax in question. One may well be loath to put an interpretation upon the word "accrue" which will require a departure from this simple rule and the sacrifice of its advantages to serve no purpose except to effectuate the Commissioner's belated reversal of opinion regarding a provision which was only of transitory importance and which ceased to be effective nearly eight years ago.

III.

The Burton-Richards Company made its returns for 1916 and 1917, not under the alternative provisions of Section 13(*d*), but under the provisions of Sections 10 and 12(*a*). That being the case, there can be no dispute that its 1916 munitions tax was deductible in 1917, the year when it was paid.

(a) *The returns were made on the statutory cash basis under Sections 10 and 12(a).*

The Government concedes (Brief, pp. 4 and 5) that if the Burton-Richards Company made its return on a "cash basis", its munitions tax for 1916 was deductible in the year in which it was paid and not in the year in which it accrued. If, therefore, in view of all the facts, the Company's 1916 return was made on a cash basis, it is clear that the appellant's case must fail.

In the foregoing discussion it has been assumed for the sake of argument that in view of the method in which the Burton-Richards Company kept its accounts in the years 1916 and 1917, and the manner in which its returns for those years were made, it may be said that such returns were made under the provisions of Section 13(*d*), and not under the provisions of Sections 10 and 12(*a*). The fact is, however, that, as the Findings of Fact show, the returns of the Burton-Richards Company for the years 1916 and 1917 were made in all particulars on the statutory cash basis, a basis which was specifically authorized and sanctioned by Congress in Sections 10 and 12(*a*) of the 1916 Act.

In making its return for 1916 the Company included as gross income, as it was required to do under Articles 91 and 92 of Regulations 33 (Revised), all items of sales in the form

of accounts receivable, whether or not in fact received. It claimed as deductions:

(1) All items of general expense in the form of accounts payable, whether or not paid in cash,

(2) A certain amount for depreciation charged off,

(3) Interest paid, and

(4) Taxes, domestic, paid.

Admittedly this return was not made on a literal cash basis. But it was made in all respects on what may be termed the statutory cash basis, a basis which, as pointed out heretofore, had become fully established and recognized as the primary basis upon which returns were made, both under the Excise Tax Act of 1909 and the Income Tax Acts of 1913 and 1916.

The fact that the Company took up as gross income and claimed as deduction for business expenses items in the form of accounts receivable and accounts payable does not warrant the conclusion that the return was not made on the statutory cash basis, when interest and taxes were taken in the return only when paid. This method of computing gross income and general expenses had been recognized and required under the Acts of 1909 and 1913, Acts under which returns admittedly could be made only upon the statutory cash basis. The same method of making return was recognized and required under the Commissioner's regulations issued upon the passage of the 1916 Act, and it was not until sometime in 1921 that the Commissioner first took the position that a return made on the basis employed was not a statutory cash return. On the other hand, if the return was made under Section 13(*d*) it was admittedly incorrect, as evidenced by the action of the Commissioner in refusing to accept it. Under these circumstances it would seem obvious that the return as made must be taken to have been made under Section 10 and 12(*a*). That being the case,

it follows, as is indeed admitted by the appellant on pages 4 and 5 of its brief, that the Company's 1916 munitions tax was deductible only in 1917, the year in which it was paid.

The Evidence of Election to Use Section 13(d).

Furthermore, the right to make return under Section 13(*d*) was optional with the taxpayer, a fact which indeed is frankly admitted by the appellant on page 26 of its brief. But the optional alternative accorded by Section 13(*d*) needs no admission to establish the fact. The phraseology employed in this Section is:

> "A corporation * * * *may,* subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, * * *" (Italics ours.)

Recognizing the permissive and optional nature of this Section, the Secretary of the Treasury in T. D. 2433, approved January 8, 1917, which is set forth in full on page 51 of the appellant's brief as part of Appendix A, specifically provided:

> "Under this provision [namely Section 13(*d*)] it will be *permissible* for corporations which accrue on their books", etc. (Italics ours.)

And again:

> "In cases wherein * * * corporations set up and maintain reserves to meet liabilities, * * * it will be *permissible* for the corporations to deduct", etc. (Italics ours.)

Section 13(*d*) being optional with the taxpayer, obviously it is necessary that if a return is made thereunder, there must be some evidence of an election so to make the return. The evidence of record conclusively negatives such an election. All the items appearing on the Company's return for 1916, namely, items of gross income, business expenses, deprecia-

tion, interest and taxes, are correctly taken on the statutory cash basis authorized in Sections 10 and 12(*a*).

Upon the appellant's theory, the only difference between returns under Section 13(*d*) and returns under Sections 10 and 12(*a*), would, in the case of this appellee and other manufacturers, lie in the treatment of interest and taxes. Admittedly, no question arises in this case in regard to interest. Under these circumstances the fact that the treatment of taxes is incorrect on the appellant's theory of a proper return under Section 13(*d*) and is correct according to the Commissioner's regulations relating to return under Section 10 and 12(*a*), at least negatives any election to make a return under Sections 13(*d*), if it does not affirmatively indicate an election to make the return under Sections 10 and 12(*a*).

The appellant lays so much stress on the fact that in the taxpayer's return deductions were taken for Expenses General (under which the cost of goods sold were properly included) which had not been actually paid in cash, that we deem it proper to reiterate that this was required or permitted by the Commissioner in the returns of every manufacturer made under Sections 10 and 12(*a*) of the Act of 1916 or under the corresponding provisions of the Act of 1909 and 1913, from the enactment of the first Corporation Excise Tax Law in 1909. Such treatment of expense at the time it was adopted by the taxpayer undeniably constituted nothing more than compliance with the regulations relating to returns under Sections 10 and 12(*a*), and should be so regarded. The appellant is wholly unwarranted in attempting to spell out an election from this treatment because it has years after the event changed its views as to the way the items should have been treated if the taxpayers had wished to avoid being drawn into the net of Section 13(*d*).

For Section 13(*d*) as the appellant seeks to interpret it is in reality a trap instead of an option, since the only result of recourse to it would be that the taxpayer would be deprived of the benefit of a deduction for taxes in one year on the ground that they were not paid, and in the subsequent

year on the ground that they had accrued in the earlier year. The appellant at page 43 of its brief admits this fact as follows:

> "It is suggested that the shifting of the basis for income tax returns from the cash receipts and disbursements basis to an accrual basis might operate in the process to prevent the taxpayer from receiving credit as a deduction for some items which were not deductible while the cash system was in effect because not actually paid, and could not be deducted when the accrual system was adopted because they had previously accrued. Such situations do arise where a shifting basis for income taxes is adopted, * * *"

It attempts, however, to minimize the force of this contention by saying that "a corollary of the proposition is that some items of income which have been earned never have to be reported". This statement of the situation is wholly inaccurate, at least as regards all those engaged in manufacturing, mining or merchandizing, for, as we have already pointed out, all such taxpayers were required even on the so-called cash basis to report income from sales which had "accrued", so that the change from the so-called cash basis to the so-called accrual basis would not affect their gross income in any way. In all such cases, change to the accrual basis on the appellant's theory modifies only the treatment of interest and taxes, and results in denying deductions to the taxpayers under these two heads in precisely the manner indicated in the appellant's brief.

Reviewing its contentions on this point, the appellees assert that under the provisions of the 1916 Act the Burton-Richards Company was entitled to make its returns for 1916 and 1917 on the statutory cash basis under Sections 10 and 12(*a*), that the return as made was a correct return under those Sections, and that under these circumstances the Company cannot be held to have made its return under Section 13(*d*).

The Alleged Inconsistency in Appellees' Position.

The Government's whole case rests substantially on the suggestion of inconsistency. It points to diversity of treatment of taxes and expenses by the taxpayer and insists that the treatment of taxes be made to conform to the treatment of expenses. But diversity is not necessarily inconsistency, and the diversity in the nature of taxes and expenses is itself a sufficient justification of the diversity of treatment of the two items in the taxpayer's return, just as it was a sufficient justification of the diversity of treatment of expenses and taxes in all the Regulations made by the Commissioner from 1909 up to and including the Regulations under which the returns herein involved were made.

In undertaking to correct the alleged inconsistency, the Government is led into inconsistencies far greater than any of which it complains.

In 1917 the Commissioner said that the taxpayer *could not* take the tax here involved as a deduction in 1916, but could take it in 1917. In 1922 on the basis of L. O. 1059 he said the taxpayer *must* make its returns so as to take this deduction in 1916 in the face of the plain language of the statute saying that the tax could be taken in the year in which paid. The Government's position now is that the taxpayer *had an option* but must be deemed to have exercised the option by keeping its books and making its returns in accordance with the methods prescribed by the Commissioner before any basis other than that on which the taxpayer's return was made was ever sanctioned by Congress. The Government then insists that the taxpayer shall make its return on "the accrual" basis, which it explains as meaning that the taxpayer should take up in its return those items that it had "accrued" or set up on its books. The only change which it claims that this necessitates is in the item taxes. But the Commissioner does not allow taxes as set up or accrued on the books though that computation was undeniably completely consistent with the rest of the Company's accounting.

Instead he says the taxpayer must deduct taxes accrued, using accrue in an entirely different sense, that of taxes legally accrued. Finally, in order to complete the chain that is necessary to success in this case, the Government now asks the Court to revise its decision in the *Woodward* case regarding the legal meaning of the phrase "taxes accrued". All this merely to cure the so-called inconsistency with which the Commissioner found no fault until at least four or five years after the return was filed, and which turns out after all not to be an inconsistency but merely a diversity in treatment of items of a diverse nature.

Conclusion.

In conclusion, we respectfully submit that no error was committed by the Court below and that the judgment entered should be affirmed.

Respectfully submitted,

STETSON, JENNINGS, RUSSELL & DAVIS,
Attorneys for the Appellees.

JOHN W. DAVIS,
FRANK BRIGHT,
MONTGOMERY B. ANGELL,
Of Counsel.

APPENDIX A.

There appears below a comparison of the relative provisions of the Internal Revenue Acts of 1909, 1913 and 1916 regarding the respective methods of arriving at net income. The italics are ours unless otherwise indicated.

1909 Act	1913 Act	1916 Act
Sec. 38. That every corporation * * * shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation * * * equivalent to one percentum upon the entire net income over and above five thousand dollars *received by it from all sources during such year.*	G. (a) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income *arising or accruing from all sources during the preceding calendar year* to every corporation, * * *	Sec. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income *received in the preceding calendar year from all sources* by every corporation * * * a tax of two per centum upon such income; * * *
SECOND. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * *received within the year from all sources*—	(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * *received within the year from all sources*—	Sec. 12(a). In the case of a corporation * * * organized in the United States, such net income shall be ascertained by deducting from the gross amount of its *income received within the year from all sources*—
(first) all *the ordinary and necessary expenses actually paid within the year* out of income in the maintenance and operation of its business and properties * * *	(first) all *the ordinary and necessary expenses paid within the year* in the maintenance and operation of its business and properties,	First. All *the ordinary and necessary expenses paid within the year* in the maintenance of its business and properties,
(second) all *losses actually sustained* within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, * * *,	(second) all *losses actually sustained* within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any;	(Second). All *losses actually sustained* and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade.
(third) *interest actually paid within the year* on its bonded or other indebtedness to an amount, etc.	(third) the amount of *interest accrued and paid within the year* on its indebtedness to an amount, etc.	Third. The amount of *interest paid within the year* on its indebtedness to an amount of such indebtedness, etc.

1909 Act	1913 Act	1916 Act
(fourth) *all sums paid by it within the year* for taxes imposed under the authority of the United States or of any state or territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein.	(fourth) *all sums paid by it within the year for taxes* imposed under the authority of the United States or of any State or Territory thereof or the District of Columbia.	Fourth. *Taxes paid within the year* imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits.

It should be noted that while the phraseology used in the 1913 Act, paragraph G (a) is somewhat different from that appearing in the 1909 Act, in that the tax is upon the entire net income "arising or accruing" from all sources, the Supreme Court of the United States in *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, has given it the same meaning, and in the subsequent Act, namely, the 1916 Act, Congress returned to the phraseology of the earlier Act.

APPENDIX B.

Comparison of Regulations 31 and 33 under 1909, 1913 and 1916 Acts, Relating to Gross Income, Inventories, Business Expenses, Taxes and Net Income. The italics are ours unless otherwise indicated.

Regulations 31
Issued Dec. 3, 1909
1909 Act

Article 2—The following definitions and rules are given for determining the gross income of the various classes of corporations:

3. *Manufacturing companies.*—Gross income received during the year from all sources will consist of the total amount, ascertained through an accounting, that shows the difference between the price received for the goods as sold and the cost of such goods as manufactured. The cost of goods manufactured shall be ascertained by an addition of a charge to the account of the goods manufactured during the year of the sum of the *inventory* at the beginning of the year and a credit to the account of the sum of the inventory at the end of the year. * * *

In the determination of the cost of goods manufactured and sold as above such cost shall comprehend all charges for maintenance and operation of manufacturing plant, but shall not embrace allowances for depreciation of property nor for losses sustained which are to be taken account of in ascertaining the net income subject to tax under the proper heading in the authorized deductions.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 104.—Gross income of manufacturing companies shall consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the *inventories* of finished and unfinished products, raw material, etc., at the beginning and end of the year. To this amount should be added the income, gains, or profits from all other sources as shown by the books of account.

Regulations 33
Issued Jan. 2, 1918
1916 Act

Article 91.—*Manufacturing corporations*—Gross income for the purpose of returns of manufacturing companies shall consist of the total sales plus the *inventory* at the end of the year less the sum of the cost of goods or materials purchased during the year and the inventory at the beginning of the year. * * *

Article 92.—All sales made during the year, whether compensated for by accounts receivable, bills receivable, cash or other property at a determined cash value, must be included in gross income of the year in which the sales were made.

See page 17 of Gov-Ex 13(a)-13(d)

Regulations 31
Issued Dec. 3, 1909
1909 Act

Article 5. Inventories—It will be noted that an inventory or its equivalent of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year is essential in the case of certain corporations in order to determine the gross income, and in case of other corporations to determine their expenses of operation. Where such inventory or its equivalent was not taken at the close of the year 1908, a supplemental statement showing such inventory approximately must be submitted with the return on the regular form. * * *

Article 4. Deductions—The specified deductions actually paid within the year, set forth in the statute and as described in article 3 preceding, shall include all proper items of expenses and charges under the respective heads as designated.

* * *

It is immaterial whether the deductions are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowedged by the corporate officers and so entered on the books as to constitute a liability against the assets of the corporation, joint-stock company, association, or insurance company making the return.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 161. In order that certain classes of corporations may arrive at their correct income, it is necessary that an inventory, or its equivalent, of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year shall be made in order to determine the gross income or to determine the expense of operation.

A physical inventory is at all times preferred, but where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be acceptable.

Article 158. It is immaterial whether the deductions *except for taxes* and losses are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return. *Deductions for taxes, however, should be the aggregate of the amounts actually paid,* as shown on the cash book of the corporation. Deductions for losses should be confined to losses actually sustained and charged off during the year and not compensated by insurance or otherwise. Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.

Regulations 33
Issued Jan. 2, 1918
1916 Act

Article 120 * * * In all cases where inventories are taken (and they must be taken where the business consists of buying and selling commercial commodities) for the purpose of ascertaining the gain or loss resulting from the business of the year * * *.

Article 126. "Paid" or "actually paid," within the meaning of this title, does not necessarily contemplate that there shall be an actual disbursement in cash or its equivalent. *If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash,* provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis.

Regulations 31
Issued Dec. 3, 1909
1909 Act

T. D. 1742—Par. 77—Reserves for taxes cannot be allowed, as the law specifically provides that only such sums as *are paid within the year for taxes can be deducted.

*NOTE:—The words "are paid" are italicized in the official text.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 152. All sums *paid within the year* for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country, are deductible from gross income.

Article 156. *Reserves for taxes cannot be allowed*, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted.

Regulations 33
Issued Jan. 2, 1918
1916 Act

Article 191. Taxes deductible.—Taxes imposed against a corporation by authority of the United States (except income and excess-profits taxes) its territories or any foreign country, or by authority of any State, county, school district, municipality, or other taxing subdivision of a State (not including those assessed against local benefits) *and paid within the year* for which the return is made, are deductible from the gross income of a domestic corporation.

NOTE:—See also the instructions relating to taxes deductible appearing on the back of Form 1031, returns by corporations, authorized for use for the 1916 return, which instructions are as follows:

"Taxes deductible under these items are such taxes as are imposed by the United States, by any State or Territory, or by any political subdivision thereof, or by the Government of any foreign country, and are actually paid or accrued on the books of the corporation, *not in excess of the amount due and payable within the year for which the return is made*, * * *."

Self Con. Trade Tax

Regulations 31
Issued Dec. 3, 1909
1909 Act

Article 3. Net income * * * The net income, therefore, is the remainder of the gross income after making the specified deductions.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 3. The NET INCOME shall consist of the total gains, profits, and income derived from all sources (designated as gross income) less deductions numbered first to sixth, inclusive, specifically enumerated in paragraph B of the Act.

Regulations 33
Issued Jan. 2, 1918
1916 Act

NET INCOME

Article 196. Act of September 8, 1916, as amended.—The net income upon which the tax imposed by section 10 of Title I of the Act of September 8, 1916, as amended, is levied is that portion of the gross income received from all sources (except from interest on the obligations of the United States or its possessions, or on the obligations of a State or political subdivision thereof) which remains after all authorized deductions have been taken into account.

SUPREME COURT OF THE UNITED STATES.

Nos. 337 and 420.—October Term, 1925.

337	The United States, Appellant, *vs.* P. Chauncey Anderson, Lowell L. Richards, C. A. Richards, et al., etc.	Appeals from the Court of Claims.
420	The United States, Appellant, *vs.* The Yale & Towne Manufacturing Company.	

[January 4, 1926.]

Mr. Justice Stone delivered the opinion of the Court.

The appellees in both cases brought suit in the Court of Claims to recover payments of corporate income taxes alleged to have been erroneously exacted. From judgments in their favor the Government brings the cases to this court on appeal. Jud. Code, § 242, before amendment of 1925.

For the purpose of discussing the main question raised by both appeals, No. 420 will first be considered, and such additional questions as are involved in No. 337 will then be taken up.

The appellee, Yale & Towne Manufacturing Co., a Connecticut corporation, was, in 1916, engaged in the manufacture of munitions. The tax imposed by the United States on the profits on munitions manufactured by it and sold during that year, became due and was paid in 1917. In making its return for income tax for the year 1917, the appellee deducted from its gross income the amount of the munitions tax thus paid. Later the Commissioner of Internal Revenue held that the munitions tax paid in 1917 should have been deducted from the appellee's gross income in its return for 1916. There was in consequence an adjustment of the income taxes payable in those years, resulting in a net increase of the tax payable for the year 1917 of $116,044.40, which was

assessed and paid under protest and is the amount for which suit was brought.

The correctness of the determination of the Commissioner depends upon the construction of the Revenue Act of 1916 and its application to the particular method employed by the taxpayer in keeping its books of account and in making return for income tax for 1916. The pertinent provisions of the statute are sections 10, 12(a), 13(a) and (d) and 300 of the Revenue Act of 1916 (c. 463, 39 Stat. 756, 765, 767-8, 770-1, 780-1). The Act imposes a tax on net income and profits ascertained as provided by § 12(a), by deducting from gross income, expenses paid, losses sustained, interest and taxes paid during the calendar year. Section 13(d) however, provides that:

"a corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as returned . . ."

In the year 1916 the appellee set up on its books of account all the obligations or expenses incurred during the year whether they fell due and whether they were paid during that year. It entered in an account, "reserves for taxes", items of various kinds of taxes, liability for which was incurred by reason of its operations for that year, whether paid or payable during the year. Included in the reserves for taxes for 1916 were items aggregating $247,763.19 for taxes on profits from the sale of munitions during the year. The return for the munitions tax was made by the appellee in 1917, and the tax, after revision and an additional assessment, was paid in 1917, the year when it was due.

In making up its income tax return for 1916, appellee deducted from gross income all the items appearing on its books as losses sustained and obligations and expenses incurred during the year, except that it omitted from the return the items of munitions tax, likewise carried on its books, as an obligation or expense incurred or accrued in the year.

It is urged by the Government that the appellee, not having kept its books or made its tax return on the basis of receipts and disbursements, has elected to avail itself of the privilege afforded by

§ 13(d) of making its return on what was referred to in the briefs and argument as "the accrual basis"; that having so elected, it is required consistently to deduct from gross income all items appearing on its books as expenses accruing or incurred during the taxable year, including its reserve for munitions taxes, whether payable or not.

It is not denied by the appellee that its method of keeping its accounts and setting up a reserve for munitions taxes reflected its true income for 1916 or that its amended return on that basis accurately reflects its income and profits for the year. But it contends that the munitions tax was deductible only in 1917 because under the Revenue Act of 1916 only taxes actually paid during the year were deductible in determining net income for the year; and that in any case the provisions of that Act and the regulations made by the Commissioner, authorizing the taxpayer to make his returns on an "accrual" basis if his books are so kept, could have no application to tax deductions, since a tax does not accrue until it is due and payable.

While § 12(a) taken by itself would appear to require the income tax return to be made on the basis of actual receipts and disbursements, it is to be read with § 13(d) which we have quoted and which obviously limits in some respects the operation of § 12(a) by providing in substance that a corporation keeping its books on a basis other than receipts and disbursements, may make its return on that basis provided it is one which reflects income.

Standing by themselves and taken at their face value, these sections would seem to require the taxpayer to make his return on the basis of receipts and disbursements or, in the alternative, on the basis of its own books of account if they reflect true income, under such regulations as the Commissioner may make, and indeed to require the latter alternative if the taxpayer is unable to make his return on that basis.

So interpreting the statute, the Commissioner, with the approval of the Secretary of the Treasury, on January 8, 1917, before appellee made its income tax return for 1916, promulgated Treasury Decision 2433 which provides in part that under §13(d) it

"will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as

nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

It also provided in substance that when the taxpayer, following a consistent accounting practice, sets up reserves to meet liabilities, the "amount of which or date of maturity" is not definitely determinable, such reserve may be deducted from gross income. The decision also laid down a procedure for readjusting such reserves when the amount actually required for that purpose was definitely ascertained, and provided that if returns upon this basis of "accrual or reserves" did not reflect true net income, the taxpayer would not be permitted to make its return on any other basis than that of "actual receipts and disbursements."

We think that the statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent.

The Revenue Acts of 1909 and 1913 authorized a method of computing the income of corporations, which did not differ materially from that provided by § 12(a) of the Act of 1916. They required in terms that net income should be ascertained by deducting from gross income received, interest, expenses and taxes actually paid and losses actually sustained, but contained no provision corresponding to § 13(d) of the Act of 1916 by which a return might be made on the basis of the taxpayer's books of account. Corporation Excise Tax, Act of August 5, 1909, c. 6, § 38, 36 Stat. 11, 112; Corporation Income Tax, Act of October 3, 1913, c. 16, Section II, subdiv. G, 38 Stat. 114, 172.

It was pressed upon us in argument by appellees that it was found impracticable to comply strictly with the requirements of the 1909 and 1913 Acts for computing income on the basis of receipts and disbursements and that under both acts the administrative practice was established, by appropriate Treasury regulations, permitting the use of inventories and authorizing deduction of expenses constituting a liability of the taxpayer, whether paid or not, in ascertaining net income, but that those regulations did not permit the deduction of taxes except in the year when paid. From this it is argued that Congress, by re-enacting in § 12(a) of the Act of 1916 the corresponding provisions of the earlier acts,

adopted the settled administrative practice, and that accordingly under that act, as well as under the earlier acts and Treasury regulations, taxes could be deducted only in the year when paid.

This argument would have force had Congress stopped with the enactment of § 12(a). By thus adopting, without material change, the corresponding provisions of earlier acts, Congress might have been deemed to have recognized and adopted the established practice of the Department interpreting and applying them. *National Lead Co.* v. *United States,* 252 U. S. 140. But, in the Act of 1916, Congress added § 13(d), which did not have its counterpart in earlier legislation. This section went further than any previous regulation by authorizing the tax return to be made on the basis on which the taxpayer's books were kept, provided only that the basis was one reflecting income and the return complied with regulations made by the Commissioner.

Treasury Decision 2433, to which reference has been made, was in harmony with this view of § 13(d). It recognized the right of the corporation to deduct all accruals and reserves, without distinction, made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income. If the return failed so to reflect income, the regulation reserved the right of the Commissioner to require the return to be made on the basis of receipts and disbursements.

A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements for a business of any complexity, which had been experienced in the application of the Acts of 1909 and 1913 and which made it necessary to authorize by departmental regulation, a method of preparing returns not in terms provided for by those statutes, indicates with no uncertainty the purpose of §§ 12(a) and 13(d) of the Act of 1916. It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the

year the total cost and expenses attributable to the production of that income during the year. The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained. The taxpayer being unable to make its return on a strict receipts and disbursements basis, and not having attempted to do so, could not have complied with § 13(d) and Treasury Decision 2433 by deducting either accruals of interest or expenses alone without the other, or without deducting other reserves made on its books to meet liabilities such as the munitions tax, incurred in the process of creating income.

Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. It should be noted that § 13(d) makes no use of the words "accrue" or "accrual" but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income—which is precisely the return insisted upon by the Government. We do not think that the Treasury decision contemplated a return on any other basis when it used the terms "accrued" and "accrual" and provided for the deduction by the taxpayer of items "accrued on their books".

United States v. *Woodward*, 256 U. S. 632, relied upon by appellees, arose under the Income Tax Law of 1918, (c. 18, Title II, §§ 210-214, 219, 1405, 40 Stat. 1062-1067, 1071, 1151). Section 213(a) and (e) of that Act provided that taxes "paid or accrued" within the taxable year imposed by authority of the United States, except income, war profits and excess profits taxes, might be deducted in ascertaining income. The claim of the taxpayer of the right to deduct estate taxes levied under that Act for the year

when due, although paid in a later year, was upheld. It did not appear whether, as here, the taxpayer kept his books on the accrual basis or whether, as here, events had occurred before the tax became due which fixed the amount of it; for it did not appear whether the deductions to be made from the testator's gross estate were ascertainable for the purpose of determining the estate tax. The question which we now have to determine was not raised, considered or decided in that case.

We conclude that the reserves for taxes which appeared on appellee's books in 1916 were deductible under § 13(d) of the Act of 1916 and Treasury Decision 2433 in its income tax return on the accrual basis for that year.

It was argued in behalf of the appellees in No. 337 that the taxpayer did not keep its books on an accrual basis; that consequently its case was not controlled by § 13(d) and Treasury regulations made under it, and that by § 12(a) it was authorized to deduct the amount assessed for munitions taxes only in 1917, the year when paid. On this point we are concluded by the findings. They show that in the year 1916 the taxpayer accrued on its books expenses, whether paid or not, including "insurance reserves," "freight reserves", "bonus reserves," and depreciation charged off, aggregating more than two and a half million dollars, which it deducted from accrued gross income, whether actually received or not, in making its income tax return for the year. It charged on its books and deducted in its income tax return, interest accrued and paid during the year. So far as appears no other interest accrued during the year and there was no reserve for interest. No charge or deduction was made for bad debts. It also set up on its books for that year a monthly reserve of $35,000 for the payment of munitions taxes beginning with September, the month of the passage of the Revenue Act of 1916 taxing munitions. On December 31, 1916, this reserve account was closed out and a charge was made on its books against the corporate surplus for account of munitions taxes of $86,541.95. No deduction was made by the taxpayer for munitions taxes in its income tax return for the year 1916. In 1917 the munitions tax was returned and ultimately assessed and paid in the sum of $112,419.54.

Since the suit was one to recover a tax erroneously exacted, the burden was on the petitioners, appellees here, to prove the facts establishing the invalidity of the tax. But the findings fail to show

affirmatively that the books were kept or the return made on the basis of receipts and disbursements. Indeed, the facts found, to which we have referred, show that the books were kept on the basis of accruals and reserves to meet liabilities incurred. It does not appear that there was any expense or liability of the taxpayer incurred by its operations during the year which was not accrued on its books. Its return was made on that basis, but omitted munitions taxes accrued on its books during the year for which the return was made. We think these facts bring the case clearly within the principle which we deem to be applicable to No. 420. The judgment of the Court of Claims in each case is

Reversed.

Mr. Justice SUTHERLAND and Mr. Justice SANFORD dissent.

A true copy.

Test:

Clerk, Supreme Court, U. S.